



M A Ventures

So you want to create a new business?

Clean Tech Conference 7/7/09 at Kiryat Ono

Presented as essential reading material for all businesses striving to grow

Financing your business with your eyes open[©]

Anticipating the next move is 90% of success, 10% is making informed decisions

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CAPITALISM

Adam Smith wrote in “The Wealth of Nations” in 1776 that the four factors of production are: land, labor, capital and enterprise. This remains true today with hardly any adaptations for any business.

Land refers to factory buildings, equipment and other tangible fixed assets. In modern times we add the need for intangible assets, also known as intellectual property – patents, **trademarks** and so forth.

Labor refers to employees and middle management.

Capital refers to finance – this is discussed below.

Enterprise refers to a number of parties over time: the person with the initial business idea; the founders who set up the business and make it happen; and the upper management leadership (CEO, CFO, CTO, etc) who consolidate and expand the business, take it public, take action against competition and recession, and so forth. These entrepreneurs do not employ **guesswork**; they develop, apply and re-develop a strategy as discussed here.

These are the elements of capitalism. Capitalism has had its ups and downs, but the alternative concept – communism – collapsed with the Berlin Wall in 1989. Communism involved central governmental planning and leadership over an entire national economy. Communism failed because profitability didn’t matter and so things were done very inefficiently and wastefully. Communism still survives in a few places like Cuba where people still drive around in cars from the 1950s...

A modern Western business must apply capitalist principles and operate efficiently according to its chosen strategy.

FUNDRAISING

Capital means money for operations. Companies large and small need finance as a car needs gasoline to run. At the research and development (R&D) stage, the planned product may be a world-beater in a few years time, but salaries and expenses must be paid immediately if we are to all live. This requires share capital. Loans may be hard to obtain if there is no income yet to repay them. And finding equity investors is not easy at that stage.

Once sales revenues begin, losses from the R&D stage must be recouped. The clients take time to pay. And when the clients do pay, some money must be re-invested in advertising, trade shows, more R&D and so forth. When raising funds, you must prepare a business plan with a budget which takes ALL the above financial needs into account and any others specific to your business.

Typically, fundraising is done in several rounds. This is because not all the money needed may be raised in one round. Many investors may want to see the company successfully achieve milestones (R&D progress, revenue progress, etc) before committing more money.



Who are the investors?

They include:

- founders;
- their families and friends;
- angel investors (private wealthy individuals);
- venture capital/private equity funds;
- institutional investors (pension, savings and mutual funds);
- the government (e.g. R&D grants from the Office of the Chief Scientist and Israel's bi-national funds; fixed asset grants from the Investment Center);
- large companies that need your product;
- employees – stock option or purchase plans to retain and incentivize good employees
- and the public if you raise money on a stock exchange in Israel, the US, London, Toronto, etc.

What do investors look for?

Investors look for good companies that seem likely to generate dividends and/or capital gains in the medium term – typically (not always) in the next 3 – 5 years. The world may be in periodic recession, and peace in the Middle East may be elusive, but a good company with a good strategy will aim to generate value for its shareholders over time.

More specifically, investors typically expect a company to have all of the following:

- A good product with unique features,
- Scientifically proven – the product works well
- Good demand for your product from sufficient paying customers. This signifies profitability and also helps to show that the technology works. The “Dot Com” bubble burst in 1999-2000 when tech companies didn't have enough paying customers and investors are keen not repeat that mistake.
- Good management – CEO, CFO, CTO where applicable and other executive management
- A business plan setting forth a clear concise strategy for profit
- A well thought out marketing strategy and a business model to translate this into practice.
- Clear presentation of the company by its senior management – a great strategy is worthless if investors don't understand what the senior management is saying to them. Usually you won't be told this, you'll receive a polite indication weeks later they found someone else or you'll get no answer at all....
- In a tech company – good well-protected intellectual property.
- Sales revenues – or at least sales contracts or other solid commitments. In practice, in a small country like Israel, most sales will need to come from international markets. Have you planned for this?
- Stable skilled employees
- All necessary regulatory approvals
- Follow-up products, applications or markets in the pipeline
- No haggling over fundraising terms.



What finance terms are reasonable?

Typically, for a private finance round, assume 4%-6% of capital raised in cash plus 4% - 6% in options/warrants. This has to be carefully structured to avoid unnecessary VAT (16.5% in Israel from July 1, 2009). Money does not grow on trees. Intermediaries who find investors you couldn't find deserve to be reasonably rewarded for their efforts according to the going market rate. If you squeeze them they will devote most of their time to other companies which don't. If you squeeze a real estate agent, he will show houses to others first before getting round to you.

What about loss of control?

If you accept outside investors, their capital will dilute the founders but will hopefully increase the overall cake to be shared out later. The founders will generally NOT lose control over the business as they are needed to run it – most investors are passive investors just bringing much needed money to the table. A few will be strategic investors who can open important doors to customers, etc.

BUSINESS MODEL

The business model of a tech company needs to be well thought out in order to translate the general strategy into practice.

Here are a few elements to consider:

- The marketing strategy – how will you find customers? How will you attract them to your product? What will be your pricing policy?
- You should sell products or should you provide them as part of a service under your control?
- Is a BOOT (Build Own Operate Transfer) model likely to make you more money?
- Should you provide the basic product cheaply but charge a lot for consumables/replacement parts later?
- Is it easier to license the IP to third parties for a royalty or franchise fee? What about withholding taxes on these?
- What will be your optimal supply chain? Which company(ies) in the group will purchase raw materials, hire labor, process, distribute and sell to customers?
- Where will you establish companies? Remember that American customers prefer to buy from Americans, Japanese prefer to buy from Japanese, etc.
- How will international operations be managed?
- Which company will own the intellectual property? How will it conduct R&D? How will it make the IP available to other companies?



So you want to create a new business?

- Which company will manage business risks and how? There may be many risks – bad debts, currency risks, product defects, inventory theft, country/political risk, etc. Are there insurance or hedging or regulatory approval needed?
- Do you have a well-planned international tax strategy? Most Israeli tech companies expect other countries tax authorities to share in their Israel R&D –related losses – but they won't. Most Israeli companies fail to check out withholding taxes and VAT or sales tax on their revenues even if they are not yet in profit. Also needed is a transfer pricing policy – tax authorities around the world (including Israel) require related companies to conduct transactions between themselves on arm's length market-based terms. This requires a transfer pricing study and is an opportunity for tax planning.

FINALLY

Always do your homework and consult professional corporate advisors about your business just as you do with technical advisors for your product/technology.

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