How Entrepreneurs Can Survive Capital Crises

Jeremy Wiesen

Even though today's market is a poor one for IPOs, a number of financial strategies can bolster a company to help it go public in the future.

Last October's stock market crash decimated the market for initial public offerings (IPOs). Many companies that were depending on going public for needed capital—particularly small and emerging companies—now find themselves in a survival mode that challenges even the best of today's entrepreneurs.

For companies that are still determined to go public, here are a number of steps to consider.

Restructure the IPO

At present, although few companies are being brought public, it is important for the entrepreneur to keep working with the underwriter so that his company will be in the best position to go public when the new-issues market revives. Prior to the crash, the time that was invested in preparing a business plan and in drafting a prospectus puts the company in a preferred position in general, and especially with the underwriter.

However, there are several changes in the structure of the IPO that should be considered to help increase the chances of a successful public offering. Such changes either "sweeten the deal" for the public or directly reduce the underwriter's traditional risk.

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Sweeten the Deal

- ☐ **Lower the company's valuation.** The crash of 1987 dampened the outlook of many investors. This can be seen in the lower P/E ratios of publicly held securities. Therefore, any discussion with the underwriter must begin with a lower P/E multiple for the company. Of course, if operating results have improved, the company's valuation might be raised.

- ☐ **"Lock up" shareholders for two years.** In a poor new-issues market, the entrepreneur will have to be satisfied to sell only the company's stock (in the IPO), and not any individual investor's stock. The company will receive all of the proceeds of the offering.

  As an additional inducement for investors, substantial shareholders and management should agree to not sell their stock for a certain period of time—such as two years. This will help convince investors that there will be a good after-market for the company's securities—a primary concern.

- ☐ **Sell units with warrants.** A unit consisting of common stock (or convertible debt or preferred stock) and one or more warrants that can be used to purchase additional shares gives the investor an extra inducement to participate in the offering. Many small underwrit-

ers would routinely put this "sizzle" into their deals. In today's current investment banking environment, medium- and large-size underwriters will have to consider the same. The warrant not only allows an investor to purchase more shares of the company at a reduced price (when the stock price rises above the exercise price of the warrant), but the company will also receive additional capital from the exercise of the warrants.

Reduce Underwriter's Risk

☐ **Lower the size of the offering.** In a depressed market, this will be attractive to the underwriter, but assurances are needed that the company can raise sufficient capital. The company will be in a position to rewrite its "use of proceeds" sections for a lower figure if it lowers its goals, raises additional bridge capital, or restrategizes its plans. The underwriter can also take some comfort if warrants were issued in connection with the stock offering because a conversion of warrants would provide new capital.

☐ **Do a "best efforts" offering.** In this type of underwriting, the investment banking firm acts as an "agent" to place the offering, rather than as an underwriter and risk taker, the role an investment bank takes in a "firm commitment" underwriting. Until now, best efforts offerings were considered the province of small, poorly capitalized underwriters. Today, they can be an excellent vehicle for completing a deal with any investment house. If the company says it will take a chance that the deal may fail, but feels confident that it will succeed, the underwriter can proceed to sell the offering. It will "close" only if the requisite amount of the offering is received in an escrow account.

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☐ **Use multiple co-managed offerings.** Firm commitment offerings generally had one-to-three managing underwriters. Now underwritings may be co-managed by more than three underwriters. If the company has a long-standing relationship or even an acquaintanceship with several underwriters, it may be able to act as a catalyst and encourage them to share the risk involved in the underwriting.

Seek New Sources of Capital

The entrepreneur will attempt to preserve capital by cutting costs and raising additional capital from prior sources, such as banks and investors. Although venture capital investors become disheartened when an IPO market dries up because they cannot exit from their investments, most institutional venture capital firms have enough uncommitted funds to give further financial assistance to their "portfolio" firms. Still, new sources of capital, such as the following, must be investigated.

☐ **Corporate venture capital funds.** If this source has not been tapped, it is one to consider. The emerging company should investigate which large firms in its field, or in related fields, have established venture capital funds. The managers of these pools of capital can better understand the company and may want to make an investment for strategic reasons.

- ☐ Bridge funds. If the company is an excellent candidate for an IPO when the market stabilizes, "bridge" funds may be available to help a company survive until it goes public. The underwriter will have to convince the bridge fund managers that the IPO will be completed.
- ☐ **LBO or "deal" funds.** There are never enough good candidates for a leveraged buyout, but there are billions of dollars available in managed funds to finance an LBO or a similar deal. If the price is right, and if their charter is not restrictive, LBO firms may consider a venture capital investment in a company.

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Revenue-Raising Measures

Whether the company's goal is to go public or just to survive, it must consider active measures to reduce its dependence on invested capital. Most emerging companies experience financing difficulties. Here are eight strategies to help companies survive the capital crunch.

Seek Service or Ancillary Product Revenues

For example, a company that plans to manufacture a product but runs out of capital might consider selling consulting services to that industry.

Service businesses are almost always less capital-intensive than those in manufacturing. In addition, the entrepreneur-manager usually possesses expertise that can generate revenues in the service sector; such revenues may exceed his salary and contribute to overhead.

Manufacturing plans can proceed when the IPO or venture capital markets regain confidence. Meanwhile, consulting has provided the company with a longer track record, new insights into the market, and new industry contacts.

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Everyone Sells

For example, a new magazine company was depending on an IPO for the next level of "investment spending" (marketing expenses not covered by revenues). Every member of this company, including the CEO, board members and consultants, should solicit advertising. Their contacts may help achieve the required sales threshold that the sales staff was unable to attain alone.

With new forms of marketing and distribution, such as telemarketing, interactive marketing, and various types of direct marketing, every method to gain additional sales should be considered.

Help From Suppliers or Customers

Many of the companies that intended to go public have new "proprietary" products (those that cannot be copied). Suppliers and customer-distributors have a stake in these products coming to market. An entrepreneur should seek their assistance and inform them of the new financing needs. Creative incentives, such as exclusivities, can also be granted to suppliers or customers.

Master Distributorships

The company may be able to avoid many marketing and sales costs by assigning exclusive distribution of its product to a nationwide industry leader, or to several regional leaders. In many U.S. industries, such as food, medical supplies, and heavy equipment, master distributorships are essential. Without such an arrangement, small companies that supply and service their own products can be at a serious disadvantage and may squander the proceeds from a public offering.

The entrepreneur must insist that the master distributor commit sufficient resources to the marketing and selling of the product. This agreement must contain reasonable performance standards, which will end the distributor's exclusivity if they are not met.

Sell Franchises or Distributorships

An industry giant seldom pays for the right to distribute a product; however, an independent person seeking a business opportunity might pay the capital-starved company for the right to become an exclusive distributor in his territory. The company receives up-front monies, which can be substantial, as well as continuing revenues from a committed distributor.

This solution to an entrepreneur's capital needs requires the preparation of a Federal Trade Commission disclosure document. Franchise law filing requirements must also be met in many states.

Future distributors or franchisees have to be solicited, investigated, evaluated, instructed, and provided with various supplies. It is helpful to find candidates with industry experience. It is also imperative to realize that by selling a distributorship, a company is closing off future distribution options.

Co-Packing

Also known as "contract packing," this arrangement allows an entrepreneur to greatly reduce capital needs by paying a manufacturer to produce the firm's product. Some industries have excess manufacturing capacity, but the entrepreneur must realize that entering into an arrangement with a co-packer has its dangers as well. A written agreement should include all aspects and contingencies of the relationship, including such matters as keeping secret the proprietary aspects of the product.

Conversely, if the entrepreneur *has* manufacturing facilities, *providing* co-packing would be a new source of revenue. Revenues can also be generated by providing warehousing or by leasing out part of the company's existing facilities.

Licensing

A business's patents, trademarks, or know-how can be transferred to one or more established companies in return for a licensing fee on the sale of each unit. While these fees may not be large, the licensee must commit to manufacture, market, and sell the product. This leaves few direct costs for the licensor.

If more than one license will be granted (e.g., to various regions of the country), a consulting firm can handle the process. For the international market, licensing is a useful tool regardless of the financial climate, because emerging companies seldom have the capital to establish their own presence in foreign markets.

Grant Stock Options

Even though the IPO has been postponed, if managers have faith in the company, a trade-off of salary for equity should be explored.

Conclusion

Additional obstacles to raising capital can be overcome by innovative changes in the company's plans, beyond the obvious cash cutting and the attempts at bank financing.

The entrepreneur must have a close and creative relationship with the underwriter; should seek alternative sources of capital; and should reevaluate every element of the business and search for valuable components to trade for capital, for revenues, or for other assistance. Today's entrepreneur will be assisted by the business climate of the 1980s, which has been innovative in many areas, from finance to technology to marketing.

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