

Think hard before selling a stake

Bringing investors on board can make or break a company – don't do it lightly, warns Rachel Bridge

WHEN Dame Anis Roddick needed money to open her second Body Shop, the bank refused to give her a loan. So she borrowed £4,000 from a friend, Ian McGlin, in exchange for a half-share of the company.

If Roddick had been able to get a bank loan for that £4,000 she would have been able to repay it over time. Instead, when she sold the Body Shop business last year for £652m, McGlin, who still held 22.4% of the business, received £146m.

While Roddick's equity sale clearly benefited the business at the time by enabling it to grow, there are situations where it might pay to think twice about selling large amounts of equity. When you are starting out it can be tempting to give away equity in return for a cash injection. Giving away a share in a fledgling business does not feel like you are giving away anything valuable – and unlike a bank loan or other borrowing, if the business fails you do not have to pay back your investor.



Chris Bourcier

As the Body Shop example shows, equity can actually turn out to be by far the most expensive way of raising cash. Keith Hunt, managing partner of business adviser Results International, said there were two big advantages in giving away

equity to get investment: "The attractions of equity are that it is the least risky form of finance you can get. Unlike taking out a second mortgage or spending your life savings, it will never bankrupt you. It is all in the business – so if the business fails,

investors lose their money and you still get to keep your house." The second advantage is that an investor is likely to come with added benefits. "They could be experienced company directors who can sit on your board as a non-executive and who can offer

advice from their experience, they could be your suppliers or customers, you are effectively forming a partnership with." However, Hunt said these benefits needed to be weighed up against the disadvantages of selling equity. "The biggest downside, of course, is that most people when they build up a business expect to sell it in the future and realise a capital gain. "You are diluting that capital gain because you have to give some of it away and you may feel a bit aggrieved if you have been working 100 hours a week and taking a small salary and you are sharing the money with people who have done nothing but put a bit of money in."

One way round this, he said, would be to create different classes of shares so that external investors get a small share of the upside in a sale but, say, received dividends ahead of the other shares. You should also ensure, he added, that in the event of a sale, the other shareholder was legally forced to sell his or her shares as well, a process known

as having "drag along" rights. Doug Richard, chairman of Library House, which provides research on private fast-growth companies, said that timing was crucial if you were thinking of selling equity in your business because it could make a huge difference to how much you needed to give away. Assuming you were able to stay afloat, the value of your equity would rise markedly in the first couple of years as you went from start-up to thriving business.

He said: "Any entrepreneurs who can get by without the cash for as long as possible are doing themselves a favour because whatever they can accomplish increases the value of the business and reduces the risk of the business – and therefore it means that whatever equity they do sell, they can sell less for more."

He said one of the key questions to ask when deciding whether to sell equity in your business was whether the investment you would receive in return would have a significant

impact on the business. "What sort of step-change does the capital permit? Are we talking about a huge acceleration of the business or, even more importantly, are we talking about a type of business where you need to be of a certain size before you are sustainable?" said Richard. "If you are and you are not yet at that size, then I would say take the capital. At the end of the day it is much easier to make money by owning a smaller part of a fast-growing and larger pie than it is to make money by owning the entire pie and having it worth nothing at all."

Mike Alcock and Tony Reddington have taken a case-by-case approach towards giving away equity in their business, Atlantic Link, which makes e-learning software. In the first year after starting up in 2002, they gave a 10% share and a 5% share of the equity to two directors they brought in, Richard Hyde and Sam Morgan.

Alcock, managing director, said: "We wanted them as aligned as myself and Tony to the success of the business. They were absolutely critical appointments and we thought it was worth an equity stake to have them all pointing in the same direction."

A year later he and Reddington also gave a 20% stake in the business to Sean Kelly, who runs their software-development arm in Kiev, leaving the two founders with 32.5% each. However, they decided against selling a further 20% to investors in return for £100,000 to market a new product because it did not feel right. The business grew more slowly for a while, but eventually orders started coming in and they managed without it.

Steve Hinton, chairman of QED Consulting, a business-management trainer, said: "Think through your personal objectives and preferences and then those of the business, and make sure you have got those two congruent. If they are not, then you are going to have a hard time." He warns that it is very difficult to get rid of an equity partner, not least because you are unlikely to have access to the money you need to buy them out. He said: "It is a bit like marriage. You shouldn't enter into it lightly."

Holding on: Mike Alcock went for a case-by-case approach towards giving away equity in his e-learning software business, Atlantic Link

You're diluting that capital gain because you have to give some of it away when you sell!

