FINANCIAL POST

Defensibility greenlights cash

Market potential, future growth won't win a cent

Brad Cherniak, Financial Post Published: Monday, June 08, 2009

Tyler Anderson/National Post - A Bay Street sign in Toronto's financial district.

Is this the time to hit The Street and raise some cash?

If you have decided to push the "go" button to raise capital in this market -- and it's not a bad idea to do so before you actually need the cash -- there are a few critical things to keep in mind.

For those who fit the parameters of the Canadian and U.S. private equity and later-stage venture capital niches, remembering to be defensive is critical. It's what rules the current capital markets.

The sexy paradigms of "market potential" and "future growth opportunities" have taken a back seat to defensibility, including established and loyal customer relationships, well-established and defined market niches, historical cash flow from operations, rock-solid balance sheets and stable veteran management teams.

Conditions are strongest in the private equity niche. Leading private equity investors are quite liquid and fairly energized by new opportunities to invest in established, quality companies often at much lower going-in valuations than in recent years.

Michael Wagman, managing director at Toronto-based Clairvest Group Inc., says while it may be the case that entrepreneurs will have to accept lower valuations than in the past few years, the top performers will more than make this up in the valuations they can pay for potentially highly leveraged, weaker competitors with private equity backing.

It's a much darker picture for later-stage venture capital investors because they struggle with the lack of visibility to liquidity with the initial public offering, or IPO, market dead for the foreseeable future and mergers and acquisition activity having trailed off, too .

Things are brighter for the early-stage venture capital segment. These VCs are less stressed by current market conditions, as their expected holding time for investments tend to look well past the expected length of the recession.

Tom Birch, managing partner of Montreal-based Propulsion Ventures Inc., says with the downturn in the markets, the timing is great for early-stage venture capital investors who can help build companies in a recessionary period.

"In four years, when the M&A and IPO markets recover, our early stage companies will be ripe for exit," he says. That being said, early stage investment volumes are still down substantially despite no lack of investment opportunities, and the bar for securing investment capital has been raised substantially by VCs, because they can.

Venture capitalists are defensive in focus these days , with a strong preference for recession-resistant business models and non-discretionary product or service companies. Valuations are way down and the funds are often choosing to invest in syndicates rather than alone, to reduce risk and conserve capital.

Early-stage VCs are looking for concepts that will solve businesses' intractable problems and for paths to the consumers that are still buying-- wireless, gaming and social networking being among those niches.

Defensibility must infuse the message of your investment opportunity, no matter what your business or the nature of the investment . Without it, your discussions with potential investors will likely not get far.

It is also critical to plumb the contacts and networks of everyone associated with your company for potential investors. That includes advisory board members, current angel investors, board members, other professionals around your business, such as consultants and lawyers, and friends. These days, it's like looking for a needle in a haystack.

At the risk of sounding self-serving, there has never been a better time to have an advisor -- someone who understands and knows the players in the Canadian and U.S. capital markets . Situations vary wildly from investor to investor, even in the same niche, and the public story may not match the reality.

Another important thing to remember is, expect seemingly draconian terms of investment -- especially ones that trigger in the event the company does not perform to expectations -- and plan accordingly. These can include re-cutting the pie with the investor, making changes in management, taking control of the board and even forcing the sale of the company.

"This is the time to look for partners that have been in business for a long time, with a demonstrated track record to match" Clairvest's Mr. Wagman says.

It's also a good time to analyze and quantify Plan B, whatever it is, including doing nothing. No matter how tough the offer to finance might appear, it is still worth doing if your expected payoff is better than under Plan B. Always compare apples to apples and never let emotion drive your decisions.

Draconian terms are part of the defensibility theme -- this time, the investor's. But they are often better for the company than slashing valuation. It puts the onus to perform where it should be, on the company.

It also increases the need to structure the deal right, with full and adequate funding for real needs, and carefully crafted, accurate and reasonable milestones to trigger good and bad events under the terms of the deal. Do the analysis required to figure all this out.

Now more than ever, the game goes to the player who is most prepared.

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