

## CHAPTER 2

# THE BIG DIFFERENCE: OTHER PEOPLE'S MONEY

*If you want to run fast, run alone.*

*If you want to run far, run with a team.*

African Proverb

**B**usiness is all about momentum. It was film director Woody Allen who said that a relationship is like a shark: it either moves forward or it dies. While Mr. Allen is a dubious expert on relationships, he knows how to make a point and this observation applies particularly well in business. Moving from a business model that merely supports an owner's lifestyle to a business that survives beyond the owner is difficult, but it can mean the difference between the life and death of a company. Private equity partners can be a valuable source not only of money, but of the talent that could give your business the extra propulsion needed to grow.

### **Other People's Money Gets You Moving**

Are you clear on what you want to do? Every business, surprisingly even a failing one, has opportunities that could be seized with an infusion of other people's money (OPM). Attracting investment is rather

daunting—much like your first time learning to play golf but with the top-ranked players of the club watching you. Perhaps you are feeling stuck, too. Perhaps your company is trapped in an eddy. It is time to stop hiding from the open waters and get in the flow rushing down to the ringing sea. It's time to get investors.

If you own a business you may have heard of this private equity financing idea and know it is a growing source of money for entrepreneurs in North America. Perhaps you dismiss using OPM based on the odd gruesome story loved by the media where owners start off with high hopes and are later found destitute.

“There are the popular myths,” says Markus Luft, the bristling-with-energy entrepreneur-in-residence for Roynat Capital. You, the entrepreneur, have invested your life in your company and now you believe if you invite in partners they will take over power, get you to do things you wouldn't do blind drunk, and trick you into signing over your life, leaving you penniless on the street. Luft says, “There are stories of unimaginable happenings once you cash that venture capital cheque, stories of private equity investors who switch from the passionate love affair to the bossy marriage, stripping out all the good bits, greedy for your cash.”

Luft looks serious, “Yes, finance has its rattlesnakes, as do all parts of life. There *are* opportunists lurking out there, profiteers who dismantle businesses and sell them off for a quick profit.” These investors push in a new management team with all the morals of Vlad the Impaler. They don't care if Stan the bookkeeper has served you loyally through all the bad times. There is the dark side with the pirates of equity who replace their hearts with calculators directly connected to quarterly results. “But these private equity funds' track records will not survive today's competitive markets. Management by greed is doomed to failure because they are not powered by passion,” says Luft. “Let's be clear; you do hold the power. You run the business.”

## **Time to Take Your Business Further**

There comes a time when every business has developed as far as an owner can take it. First, it is important to recognize that all companies have a life cycle. In the evolution of a business, there are

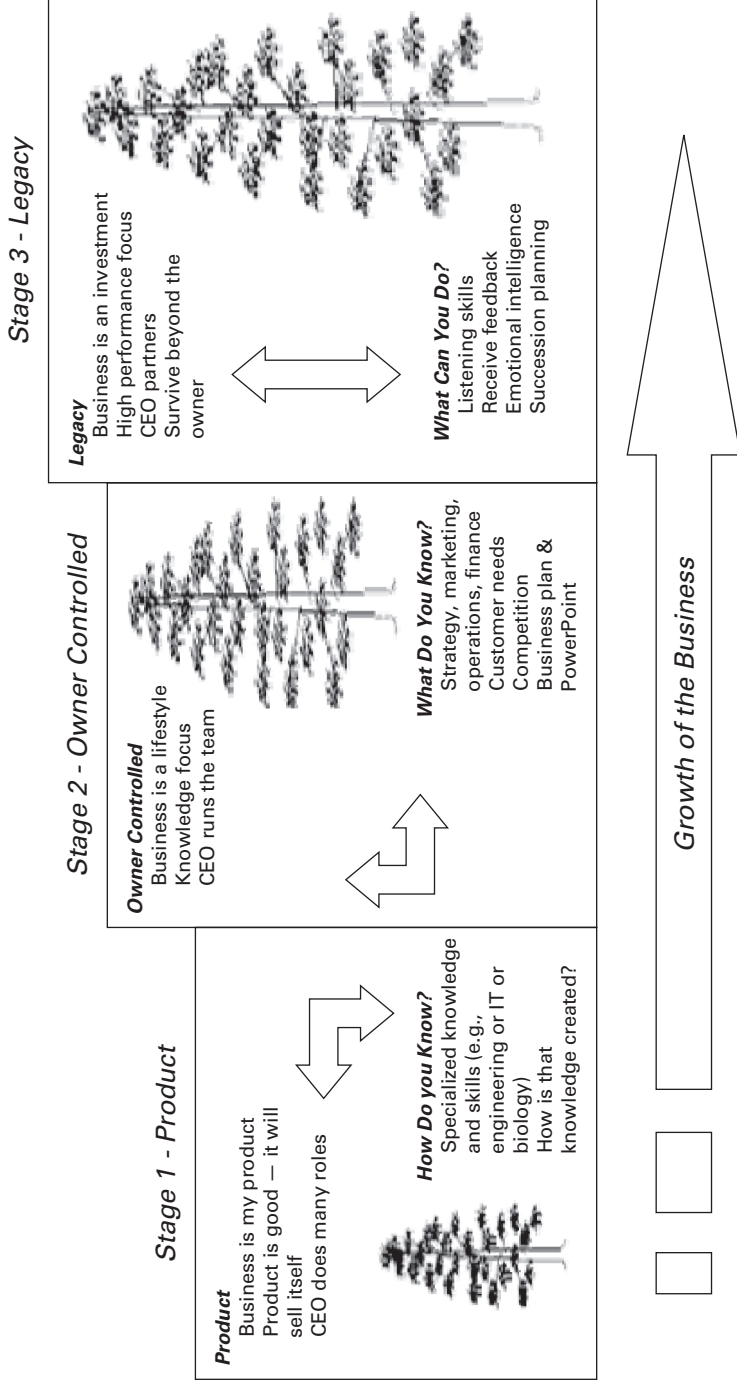
recognizable stages of growth: from that one-person band, through to the group with four guitars and a set of drums, right up to the full-blown concert complete with back-up orchestra selling out Carnegie Hall. Some companies never make it past the one guy with a guitar.

Secondly, if you are serious about moving beyond the bank to acquire growth financing, you will need to change your mindset. You need to go beyond you. At the height of their popularity, The Beatles recognized that most of their music was not being heard over their fans' shrieks of delight, so they made the astonishing decision to stop touring and record mainly in a studio. Counter-intuitive and crazy! Few other performers would turn their back on such easy money. The Fab Four also made another important decision. They surrounded themselves with professional management who had similar artistic aims and complementary skills—so they would support, and indeed push, their growth. As a result of focusing on their legacy—their art—The Beatles grew far beyond a rock-and-roll touring act and their music will survive us all. If they had kept all the control over decision making to their original band, without outsider help, they would not have achieved as much notoriety or wealth.

Make no mistake: fund managers and venture capitalists seek out companies that appear to promise a good investment. They do want to fund a business where you are deeply committed and passionate. They want leaders who want to grow the business into a legacy that goes way beyond them.

Are you at that stage where you wish to let your business grow beyond you? Perhaps you are ambitious enough to want your business to grow beyond your lifetime. You know that time creeps up awfully fast. Private equity can transform your business from an asset that merely supports a lifestyle to a professional business that can afford the rigour required to make it up to the public stock market. With private equity experts, such as Markus Luft on your board, you gain his brains and experience as the business grows because he has been there himself. With private equity assisting your company, the odds of making it are increased.

**Figure 2.1: Three Stages of Business**



Source: *Jacoline Loewen*

## What Will Make or Break You

It's an astounding fact that your attitude toward outside investors may be the most critical determinant to getting financing. Alan McMillan, serial entrepreneur, says, "80% of deals are turned down because of the attitude of the person making the pitch. Entrepreneurs are head strong, they don't listen, and the private equity guys don't want to work with someone who will not be a team player."

Do you believe an investor will be domineering? A Donald Trump-type telling you what to do? Perhaps you worry, *I'm not making enough money for investors*. Maybe you don't understand financial markets and have never explored the prospects beyond the bank. These are all common worries and it is your ego speaking. To be ready for investors, however, you first need to understand what it takes to put aside your ego and to share control in order to transition up the growth curve to be a Stage 3 Legacy Business. The chart in Figure 2.1 provides a visual representation of the growth required by you, the leader, to develop from a sapling to a fully grown evergreen tree, standing tall.

### Stage 1: Product

In Stage 1, Product, the business is dominated by the specialized knowledge of the owner, whether he or she is an engineer, scientist, or baker. The engineer, scientist, or pie-making specialist is trained to think and speak the language of the product they love—the technology, the science, or loaves of bread. They do what they know—invent new technologies, develop new medicines, or bake award-winning French bread. Many

#### ARE YOU READY FOR INVESTORS? A QUICK SELF-TEST

- Does the business need broader skills?
- Can you share decision making?
- Can you take advice and act on it?
- Do you have a succession plan?
- Do you have a written description of how partnership would look to you?
- Have you got legal information, financials organized?

smart people stay at this level because they are fascinated—smitten, actually—with their product and, frankly, are quite good at being specialists. They believe the product is so strong it will sell itself.

These people do not get caught up in managing their business—or, all too often, even themselves. If they are fortunate, they find managers to do all of the company-building, such as administration, accounting, marketing, and watching the bottom-line figures. To assess how ready you are to move up to the next stage of business, answer these questions:

1. What's your idea of success? Are you in business to get wealthy? Many people really want a nine-to-five type of job so they can play in the jazz band on Mondays, go to their kid's soccer game, volunteer, or whatever. There's no room at the top if you are in business for lifestyle reasons.
2. Are you doing this for your ego? Most entrepreneurs start out wanting to make money *and* run the show. Research proves that if you do not decide which is more important, you will end up being neither wealthy nor controlling a strong business. Be able, when the time comes, to invite in partners and share the control to grow to the next stage.
3. Could you do better working for someone else? Engineers can create the best technology that never gets bought by a customer because it is simply too risky to award the project to a small, untested company. They would achieve more by going under the umbrella of a larger business that can protect their inventions with patents and take them to market faster through the sheer power of their brand.
4. How are you with cash flow? In your business plan (here's hoping you've got one), do you make assumptions about money coming in and flowing out. Like a renovation project for your home, think about the advice "Double the contractor's estimate of the time and the cost." That applies to business plans too.
5. Does money matter? Yes, it does. You must charge for your work, as you need to pay the bills. Otherwise, you are not an entrepreneur; you are a hobbyist. The toughest skill is to convince someone to put her hand in her pocket and hand money to you. Top entrepreneurs get clients to pay again and again for more and more.

### ARE YOU READY TO MOVE TO STAGE 2?

1. Which do you want—to control your business or to get wealthy? This is the decision you need to make early on as it will influence your decisions.
2. Have you delegated your work to others or are you still writing your own marketing material, etc?
3. Do you focus on cash flow?
4. Are you charging enough for your products or services?

## Stage 2: Owner-Controlled

Moving up, a Stage 2 Owner-Controlled business involves a more formal structure. Knowledge is built up around the product or service, and converted into formal strategy, policies, plans, and budgets in order for more people to create the products. Stage 2 encompasses marketing plans, accounting systems, operating processes, and so on. You can demonstrate that your management team skills go beyond the “product coolness” focus of Stage 1. The “doing more” forces your business to move beyond the one man with a hamburger joint up to a chain of branded McDonald's, or from that one bakery up to Ace Bakery supplying French loaves to grocery chains, or from a club of programmers sharing photographs with each other for kicks up to the online photograph community called Flickr (a Canadian start-up eventually bought out by Yahoo! Inc. in 2005). But even a Stage 2 Owner-Controlled business, with its systems and controls, may not yet be ready for formal investors.

Here is the crux of how to attract financing: the difference in performance between Stage 2 and Stage 3 companies is the attitude of the leader. *It all starts with you.*

Stage 3 Legacy leaders are ambitious enough to put aside their own egos in order to create a company that can succeed without them always sitting in the captain's chair. They recognize that for the company

Many businesses that make the transition from Owner Controlled to Legacy, from making a living to building a long-term, sustainable business, take on investment partners.

to grow, they must move beyond being the only star and embrace the change introduced by private equity partners.

### Stage 3: Legacy

The Stage 3 Legacy Company refers to the state in which a business is best able to receive funding from private equity, including venture capital. Leaders of Stage 3 Legacy companies understand the evolution of their business. They know that in order to make the transition to Legacy status changes will be required—equity partnership being one. The owner-entrepreneur who makes the conscious decision to move from an Owner-Controlled to a Legacy business will discover private equity partners can move them to the next level of wealth.

### New Rules for Your Leadership Style

Love it or hate it, contestants on *American Idol* have to endure pitiless and very public critiques of their performance by a panel of judges. The judge's role is not to coach the performers, but to decide which singers can possibly sell a massive number of records—in other words, make money. After all, judge Simon Cowell has put his *own* cash into winning performers.

Yet, invariably most singers (and much of the audience) seem confused about Simon's role, looking for slobbering approval as if he were their patient, supportive coach. Wrong. Think about the many cringe-worthy singers who angrily responded to Simon's criticism by saying, "What do you know, anyway?" (Presumably, a great deal about what it takes to get music fans to shell out twenty bucks for an album.) These sulky singers would have benefited far more by demonstrating the emotional maturity to listen and actually prompt Simon for more comments, as he is well worth hearing out—albeit ruthlessly blunt.

Take a good, long look in the mirror. Do you take feedback as a massive assault? Do you immediately launch a missile at your attackers, thinking, "This will show them?"

A private equity relationship begins with the intensity and candidness of Simon. Investors will hold you up to the cold, unforgiving light of day to judge if your business could make money in the future. As they go through the steps of deciding whether to give you their cash, they are not going to coach you on your next steps or how to improve.

When their criticisms flow, will you have what it takes to listen? Will you move on to the next round or are you one of those *Idol* wannabees furiously stomping off the stage, too insecure to hear the realistic comments you need, oh so badly, to hear?

“Ninety-five per cent of people are just not built the same as entrepreneurs,” says Alan McMillan, serial entrepreneur. “They would get too discouraged from all the rejection to continue. But those who succeed are able to treat criticism well—almost with the dual ability of treating it as water off a duck’s back while also absorbing the important points. Those emotionally developed entrepreneurs get financing. Emotional control can be learned.”

## Can You Attract First-Round Money?

### SHOULD I LOOK FOR OUTSIDE CAPITAL?

. . . If you answer yes to one or more of these questions:

- Do you need money to grow or for an acquisition?
- Should you be reducing your personal risk and taking some money out of the company?
- Could your knowledge or strategy benefit from outside expertise?
- Do you have new ideas that will require capital to fund?

Not surprisingly, the start-up company spends a healthy proportion of its time at Stage 1, Product. But to attract the first round of money (venture capitalists or private equity fund managers), the owner needs to move at least to Stage 2. In order to move from the first stage of Product upwards, you need to face a critical dilemma. Answer honestly, as early as possible, how you define your success. Is it being king of the joint or making money? Research by Noam Wasserman shows that except for the few stars like Richard Branson and Anita Roddick, it is rare for founders to take their business to an enduring, wealth level of business. Wasserman says, “A founder who gives up more equity to attract investors builds a more valuable company than one who parts with less.”<sup>1</sup> If you decide you

<sup>1</sup> Noam Wasserman, *The Founder’s Dilemma*, hbr.org, February, 2008, page 105.

want to make money, you will realize that there comes a time when you cannot do it all and you need to give over equity to partners.

This first round of financing tends to focus on the business plan, the two-minute description of the business purpose (elevator pitch), and the PowerPoint presentation. The entrepreneur who is certain to get the approval, never mind the stage of development, is the one who can combine business acumen with emotional maturity that appeals to investors—and that's Level 3, Legacy. These CEOs manage all the steps in Stage 1 and Stage 2 but know that the crucial decision to invest will only be made if they can accept rejection of their ideas and business, learn from feedback, and know that getting investors is a privilege.

As you enter the negotiation process, you will be tested to see if you are able to learn (are you curious about different ways of doing business, rather than grimacing uncomfortably at suggestions, as if your mother had just asked if you've brushed your teeth and tidied your room?). From the first moment of contact, the investor is examining your response to curve balls and interrogative comments. Do you get defensive? Are you touchy about questions regarding past performance, making excuses for what happened rather than exploring the problem in depth? Do you embrace dissenting opinions? Are you a good listener? The answers to these touchy-feely questions will help the investors decide whether they would enjoy working with you over the next five years.

Reality TV, despite the criticism, does attract loyal audiences because viewers are intrigued by the raw human interaction. If *American Idol* is not your taste, then there's CBC's *Dragons' Den* where five seasoned, self-made gazillionaires listen to early stage company owners pitch for investment money. The fieriest Dragon, Kevin O'Leary, believes the attitude of the leader when getting grilled by investors is the most influential factor in attracting investment. He says, "I don't know why fortune smiles on some and sets the rest free, but maybe the answer lies in the strength an individual gets in dealing with rejection."<sup>2</sup>

---

<sup>2</sup> Kevin O'Leary, "Lessons from the Dragons' Den," *InTouch*, Richard Ivey School of Business, Winter 2007, page 60.

## The New Competitive Advantage: Skills

Stage 3 Legacy companies recognize that with the availability of private equity to smaller companies, a CEO's number one skill must shift from sourcing capital to pulling together the world's best skills. Over the past twenty years, capital has been reduced to a commodity. Smart owners and CEOs recognize that competitive advantage in the future will arise from the business's ability to partner with talented people. Here's the beauty of private equity—they share the capital risk as well as bring an extraordinary range of creative contributors to learn together and risk new ideas (some whacky, some strange) to grow the business.

Stage 3 company owners recognize this shift from capital to skills and that private equity underpins with capital and reinforces team skills.

How do you decide if you want to consider private equity? That question isn't enough by itself. It needs to be paired with a second question: How do you judge success? Do you say, "I want to partner with private equity and get a bunch of money," while rubbing your hands together and grinning like Jim Carrey? Or are you the Stage 3 CEO who says, "I want to build an enduring legacy—a business that works without me."

## Face Up to Your Financial Reality

Whether you are part of a family running a business, a lone entrepreneur, or a manager in a neglected corporate division, you can benefit from additional capital and professional stewardship. If you want the business to grow or you wish to reduce your risk exposure, or both, it may be wise to diversify your assets. Private equity will allow you to take some money off the table so that your business does not represent all your net worth. Some owners do it early in the business, some close to retirement. "CEOs who sign up with private equity funds often have 99% of their net worth in their company—the equivalent of putting all your money into one stock," says Greg Milavasky of Canterbury Park Management. "The CEO who signs up with a fund now gets the benefit

of taking some money out to diversify elsewhere but also benefits from the discipline that private equity brings to develop their business.”

Running your own business is deeply personal, and you are not alone in being reluctant to bring in partners, because then you will have to face your financial realities. It’s a scorecard that reveals your level of success and the majority of owners, whether they are pulling down a six-figure income or not, think that their scorecard should be larger, better, and more impressive.

When you need expert advice on a particular health issue, you visit the doctor. Before the examination, you may feel embarrassed to bring up your “problem.” But once the doctor elicits a description of your symptoms, you usually feel relieved and much more at ease at having learned what is really going on. You may even wonder why you ever thought you couldn’t face the “problem.” It’s much the same process with private equity.

Are you afraid of being told no, your business is not worth that much, that you are washed-up, that you can never retire, that you’ve wasted your life?

Big—and costly—mistakes happen if you are the sales-focused entrepreneur who ignores the company’s future financial growth. Just because you cannot see the potential of your business, don’t make the common mistake of thinking your business does not have enough to interest investors. If you have paying customers, trust me, there will be interest.

## **Make the Two Most Important Decisions**

“OK,” so the Stage 3 Legacy owner says, “I want to see this business expand aggressively. This is not an Owner-Controlled business. I want to see how far this business can go—maybe even to being a Fortune 500 company.” This is a fundamental and deeply personal decision, to go for the Stage 3 Legacy and seek private equity partners, as each owner has a widely differing set of decision criteria and risk parameters.

It is impossible to reach Level 3, and take on private equity, without answering two questions honestly:

*Decision 1: Do I need to be in personal control of the business?*

Do I have personal comfort with a partnership with strong, talented people? Will I be able to let go of control? Do I have the

skills to be a team player? Does success mean leading my own team or can I step aside to share control or even move out of the CEO role?

*Decision 2: What level of risk can I bear?*

How much of this company do I want to personally carry? Could I do more for the business with other people's money (OPM)? How much money does the business realistically need—\$500,000, \$1M, \$2M, \$5M, \$10M, \$21M, or more? How much do I want my partners to help me? Would I like to reduce my risk by selling off an equity stake by 25% or maybe 75%?

## Decision 1: If Personal Control Comes First

Ten years ago, a food company in the U.S.A. had aspirations to grow and build a new plant. It was getting close to signing up private equity partners, with 51% control over to private equity partners, when the CEO called Ed Rieckelman, who now heads up True North Investors, for a meeting. He said, "You know guys, I've run this business by myself for twenty years and I don't think I'm able to answer to anyone else. I don't think I would make a good partner. At first I was excited about it, but then I realized I'm too set in my ways. I think I'm going to stick with bank debt, which requires nothing of me."

This feisty entrepreneur knew that he was a Stage 2 business and content to remain as captain of his own ship. A Stage 3 owner would be ambitious enough to put aside his ego and move over to make room for other experts giving strategic opinions. This food company expert knew he had taken the business as far as he could on his own. For his business to move to the next stage of investment, he knew it would require partners, but he preferred to stay with what he knew and could control. He worried that if he opened the gate to private equity, the horse would bolt—with equity as the surprise jockey wielding the whip and charging off toward the horizon.

"We respect that owner's honesty," says Rieckelman. "Absolutely. When dealing with private equity, it is important to understand what being a partner means." Rieckelman advises owners that if personal control is very important, private equity is not for you.

### *The Dilemma of Leadership*

The irony of owner-run companies is that their current success has often grown as a result of their autocratic leadership style. The challenge of moving to Stage 3 is adapting to a team of peers—partners—and learning together. It is not an easy evolution and there will be hurt egos—probably yours. Business founders will need to rein in and even put aside that very same dominating ego and personality that pushed, prodded, and pulled the business to its current level. Only then are they ready to invite in partners. Ironic, yes, and very hard to do.

Stage 3 company owners understand the paradox of future success: transforming from autocracy to partnership will grow the business. Yet, it can be excruciatingly difficult for owners of a business to allow in partners.

Stage 3 means working hard on integrative skills from which the foundation of a Legacy business can be built. Integrative skills such as teamwork, listening, and the ability to learn by taking feedback—without feeling threatened—are the essential skills necessary to incorporate a talented team into a common vision that builds a lasting legacy. The food company owner was fond of his Owner-Controlled lifestyle and would not be able to handle other people telling him what to do—or that was what he believed, anyway. He did not want to evolve the business beyond its current size. He was happy where he was. But he could be leaving a great deal of money on the table, as well as missing out on the opportunity to grow the business into something greater, and maybe growing as a person as well.

### **Decision 2: Your Level of Investment and Risk**

The second question entrepreneurs or CEOs need to ask is how much risk are they willing to carry on their own. Being the sole decision-maker, with the bulk of ownership, raises the risk profile of the food company expert's business. What would happen if he got hit by the proverbial bus? With strategic private equity partners, his business would not need to die too. His family and employees might appreciate that spread of the risk!

Also, there is the stretch of growing a business. A manufacturing company's CEO was happily engrossed by his business and making a great deal of money. Inspired by a speech by Apple founder, Steve Jobs, however, his

dream became to grow the company more. This CEO knew that he had the drive but worried about putting so much of his personal money at stake. He could not afford to take the risk, nor could he go to the public markets at that stage. To help his company evolve, the CEO sold 75% of the company's shares to private equity partners. They helped build up the staff, create systems, and identify acquisitions. Ironically, his 25% share ownership ended up giving him *more* financial return than if he had kept 100% to himself. How incredibly satisfying when the difficult course turns out also to be the best! Of course, if you're following Steve Jobs' advice you must know the risks to growing. One additional point—Jobs may have lost his spot at Apple for a decade but he says the company made it through that period due to the private equity financial partners in place.

Risk is relative. A medical device company wanted to launch a new product. As the owner knew it would cost \$5M to bring to market, he weighed the risks. "Right now, I'm profitable. If all goes well, the product will grow my \$10M company to \$30M, with a cash flow of \$1M. If it does not go well, I'm in the hole for \$5M and it will take me five years to break even and get back to where I am now."

*Pass!*

But private equity partners will be lured to the possibility of growth. They catch a glimpse of the big fish in the dark water and appreciate the gleam of its scales; they will pick up the harpoon and take on the struggle, bleeding from holding the line, facing unbelievable adversity to bring home the fish others can only admire from the shoreline. That medical device company's CEO settled on admitting to the conservative nature of his personal and financial goals. "I built this business in my garage and now it has to fly without just me. Let's get in partners and share the risk." He got enough cash off the table to cover his retirement and compensate for all the hungry years, but he was still able to stay around to enjoy the new growth with the partners who brought valuable new skills—vision, contacts, and patient capital through the storm.

## **Decrease Ownership but Gain Growth**

As a business owner, you set your risk by the amount of shares you sell to a private equity firm. It is vital to realize that you control the level of effort the fund will bring to your revenue growth.

**Figure 2.2: Valuation and Future Value**

	<b>Controlled</b>	<b>Shared</b>	<b>Majority</b>	<b>Sell</b>
<i>Ownership</i>	30%	50%	75%	100%
<i>Partnership role</i>	Likely more silent	Board skills and strategy	“Heavy lifting” and active participation	Take over and you walk away

You can sell:

- 100% or 90% and walk away from the company. By selling 90%, you can keep shares and get some upside to the new ownership.
- 75% and keep some control but benefit from the skills and Herculean effort put in by your new partners.
- 30% and take on a minority shareholder—you cannot expect these partners to be seriously hands-on for that amount.

Private equity partners will not be motivated to do a great deal of heavy lifting for just 30% of the rewards. Stage 3 owners appreciate that the more ownership is shared by the investor, the more effort they’ll make to help build revenues (see Figure 2.2). This is your decision to make, not the private equity fund’s. You have the control.

The level of ownership by financial partners will determine how much motivation and skills you can expect from them.

### **TAKE AWAYS**

Gathering together skills and talent of the private equity investor is the competitive advantage. Your attitude is the top factor to attracting investors to your business. Your openness to moving over and sharing control is key for investors.

Decide if you want to control your business or get rich—research shows few founders achieve both.