Throwing Good Money After Bad ©

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Growing companies often require more investment capital. The management teams, of such companies, naturally turn first to their existing investors. From the investor's viewpoint, they have to ask themselves, should we invest more money in this company, or not? This article will explore some of the factors that might influence the investor's decision and consider what the company can do to improve the odds of getting the outcome it wants.

In deciding whether they should invest more money in a company, in which they have previously invested, investors may consider a number of different factors including the following:

1) How much money did they invest previously? Does the investor have any restrictions, or limits, as to how much it can invest in any one company? For each of the current investors, how close are they to the maximum amount they can invest in the company under restrictions that may be applicable to them?

2) How much capital is the company seeking in this round?

3) How much time and money is needed to breakeven?

4) How much more time and money is expected to be needed before there is a realistic chance of either selling the company, or have it go public?

5) Who are the other investors in the company, and how much did each of them invest?

6) Will any of the existing investors invest more money, and if so, how much? Who will not invest more money, and why?

7) Did the company effectively use the previously invested capital, or was such money wasted?

8) How much progress did the company make in implementing its business plan? If there were delays, what caused them?

9) What pre-money valuation is proposed for the new capital infusion?

10) Have there been any developments in the industry that benefit the company, or adversely affect it?

11) Will any new investors participate in the new proposed round? If so, who are they? What is their reputation? How much will they contribute in the proposed financing? How much could they invest in future rounds, if needed?

From the Investor's Perspective

At times investors may contribute more money to a company in which they've previously invested, because they continue to believe in the management team, and believe that the company will be successful. They also want to make money on their investment. As an investor, I remind myself that I cannot indulge in dreams, but must rather deal with reality. Many people find it difficult to deal objectively with a company that is in trouble.

The psychological hurdle that must be overcome, is to acknowledge that the company is in trouble. This is difficult, because it may shatter our dreams and hopes of making a profitable investment, and it may force us to acknowledge that we made a mistake in making our initial investment.

Entrepreneurs are generally optimistic, enthusiastic, "can do people". They must have these qualities in order to start a business because the odds clearly do not favor them. If entrepreneurs made a cold, hard analysis of the odds of success, they may not even start the company. Enthusiasm, tenacity, and persistency are often necessary ingredients for business success. However, the same ingredients may impede, or inhibit, the management team's ability to view the company and its competition objectively. This is where a venture capitalist's perspective can be helpful. We certainly do not want to discourage the management team, but we often have to bring them down to reality, and force them to deal with difficult issues that they would otherwise ignore.

From the Company's Perspective

Honesty really is the best policy, and I urge management teams to tell it like it is. As an investor, I would much rather hear about problems, or potential problems, as early as possible, because that is when the company's options to deal with them are the greatest. As problems linger, they often grow, and the options to resolve them diminish. Management's credibility is also a significant issue. Once I determine that an executive has lied to me, or has mislead me, my faith in such executive is reduced, and from that point forward I may question everything they say.

The management team should understand and address the potential investor's concerns and questions. The management team should also be able to address each of the questions raised above. In particular, if the company has struggled, or has not achieved as much progress as initially expected, the management should address such problems directly, rather than avoiding the issue. Management can, and probably should, put a positive spin on the problems by noting them, explaining how the management team can address them, and what they have learned from them. Companies frequently make mistakes, and that is to be expected. However, investors hate to see the same mistakes being made repeatedly.

Existing investors are more likely to invest additional money, if they see new sophisticated investors also investing in the round. Consequently, the management team can help itself by finding new investors themselves.

Conclusion

I think it's clear that many investors, including venture capitalists, got carried away with euphoria during the ".com craze." and allowed greed to overcome logic and common sense. Similarly, in this environment, I believe many investors are overreacting, and as a result it is extremely difficult to raise capital in this environment. Many well-managed companies, with great potential, are finding it difficult, if not impossible, to find additional capital. For companies that need additional venture capital, I would urge them to focus on it intensively. They need to understand that the capital raising process will take longer than it otherwise would take if the financing environment were better. They may simply have to do deals that they do not like. In this environment, the pendulum has swung back to favor the investor – the one with the gold is now making the rules. Undoubtedly, conditions will change in the future, and the pendulum will swing back to favor entrepreneurs. Exactly when the conditions will change is impossible to predict.