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Keep it simple, stupid

Need an investor to help your startup company grow? A tidy, transparent balance sheet is the way to go, advises angel investor Scott Gilmour

MOST ENTREPRENEURS set up in business to make money. Fair enough — that's the purpose of business. But too many entrepreneurs expect too much for too little.

In the first three years of my career as a mentor capitalist I talked to 120 young tech companies and looked over at least 50 balance sheets, and it's not a pretty sight. In almost every case, the nakedly obvious purpose was to give the founding entrepreneur majority ownership of the funded company, often while risking little of his or her own money.

Here is a small sample of what I've seen in business plans and investment memorandums seeking to raise outside capital:

• A software developer that had only $800 in equity investment and almost $150,000 in shareholder loans. That $800 sends a pretty clear message to potential investors about how much faith the founder has in the company.

• A niche manufacturer with less than $30,000 in equity investment and over $500,000 in shareholder loans.

• A web development company with such a complicated company structure that I needed to draw a diagram to understand it. The essence was that any new investor's cash would go into wholly owned subsidiaries, which — if they were wildly successful — would end up owning a small percentage of the parent company. This meant the founders retained almost full ownership of the parent company, while transferring all the costs and risks onto these subsidiaries.

• A biotech venture with a labyrinthine structure featuring debentures, shareholder loans, multiple classes of shares, and two mirror companies (one holding the intellectual property, the other the operations). But the real kicker was that there was an accrued liability for over $100,000 of directors' fees. This for a company that hadn't produced that much in revenue in the past two years of shipping sample product!

At least with the first case, the founder was willing to redefine the loan as a "deferred liability". But even so, any potential investor would quickly see that their money could wind up repaying the founder's loan rather than funding the growth of the company.

With the second example, the real shocker was elsewhere in the information memorandum, where the intended use of funds was shown. Over half of the new equity being sought was to pay off the founding shareholders' loans — entirely. After the cost of building the prototype unit, this left a mere $60,000 for "marketing" — a trifle short of what would be needed for the company's planned entry into the US.

What is especially troubling about these examples is that they came out of environments run by people who should know better, including university incubators, angel investor groups and venture capital-backed companies.

So why do these entrepreneurs create such problems for themselves? Is it naivety, greed or bad advice? Possibly there's a combination of factors at work, but largely I blame the lawyers. And the accountants. Who else, other than people who charge by the hour, would invent such complexities as multiple classes of shares, owning the intellectual property in separate companies, complex holding company structures, and so on?

MATHEW CLARK

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These strategies may be appropriate in some situations, but in a startup, complicated legal structures are a waste of time and cash.

In yet another example of questionable professional advice, I designed an employee share option scheme for a startup company in which I invested. When the company's accountant reviewed the plan, he recommended employees be given additional salary, and encouraged to buy shares instead. He argued that if the options became valuable, the company would have to pay PAYE on the deemed income but would not receive the associated tax deduction, whereas the increase in salary would be a tax-deductible expense for the company.

This advice may well be the most tax-efficient, but it ignored the obvious: the startup didn't have enough cash for market-based salaries, but still needed to create a sense of ownership and incentive among the staff.

Instead of pouring time and money into complex structures and becoming bogged down by unproductive accounting and legal technicalities, startups should keep things simple. I recommend to the startups I work with that there should only be one class of common shares, at least until the first venture capital investment. Different timing and risk levels can de determined simply by adjusting the price of the shares, rather than using multiple classes such as A and B shares, preference shares, and so on.

Setting up an employee share option scheme is a great tool for recruitment and retention of staff. It's low cost and well understood by professional investors. (It's worth noting that well-publicised problems with option schemes in the US are a result of poor operation and oversight, not a failing of the concept itself.) Options are also a great way to recognise the contributions made by the likes of mentors, directors and professional advisors.

As for creating separate companies to hold intellectual property or to shield the founding investors from risk, these schemes simply increase your legal costs because they'll need to be unwound before taking on professional investors or completing a trade sale.

Keeping it simple has a number of benefits:

- It's easy to explain to your angel investors and staff, some of whom may not have in-depth financial expertise.
- New investors are encouraged by a clean balance sheet, rather than being turned off by complexity and confusion.
- Legal and accounting fees are reduced, so the most critical resource — cash — is spent on the key tasks of product development and marketing.

Many Kiwi entrepreneurs struggle to accept that it's better to own part of an elephant than to own all of a fat mouse — in other words, to have 10% of a $100 million company, rather than 100% of a $1 million company. Having co-founded a software company in the US, I know how hard it is to let go of ownership and control, but it's the only way to ensure success. That's because no single individual has sufficient skills, time and capital to grow a startup into a globally successful company. They must attract, retain, motivate and reward investors and staff — and that is much easier with a clean and understandable balance sheet.

If you're still not convinced, pause for a moment to consider the case of Howard Schultz. He's transformed the Starbucks name from a small Seattle coffee roaster to a worldwide brand in under 20 years. How much of the elephant does Schultz own these days? Just 3.9% of a company that's worth $US15 billion.

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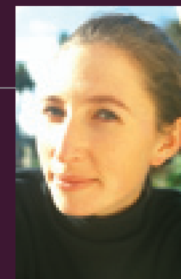

Wise words for workplace woes

What resources should I be looking at if I feel my career path has lost direction?

While I'm loath to lament the passing of a time when you left school, often bypassed a tertiary education, and went straight into a job which lasted you until you retired — it has to be said it created less pressure to soar through the ranks and leap from one high-power role onto the next.

These days we talk about "career paths" instead of jobs, and there's exhausting talk of maximising opportunities. But it's not all bad.

Director of The People Business and e3 Leadership, Brenda Sayers, says career paths certainly don't follow a direct route any more, but there are far more opportunities for employees to actively guide the jobs process.

"We are responsible for developing our own career and navigating the opportunities and barriers along the way. This means you need to establish a plan and take steps towards your goals," says Sayers.

For guidance, Sayers suggests checking out the career section in your local library or bookstore for titles that provide a simple framework for career planning, clarifying your skills and drivers, matching these to a range of career roles, identifying development areas and tips for preparing for change.

Career counsellors are an option if you're really having trouble figuring out where you want to go next. Another handy tool before you start applying for jobs is to write a list of all the things you found positive, negative and interesting about your previous jobs. That way you've got a good basis on which to make judgements about prospective careers.

Finally, a readily available resource (and it's free!) is to ask everyone you know about their jobs and what they like and dislike about them. You don't have to confine your job enquiries to friends either — most people you meet will be more than happy to give you a ten-minute rundown on what they do.

I read somewhere that a twenty-year-old entering the workforce can expect to have upwards of 16 different jobs in their working lifetime. How can an employee equip themselves for this kind of rapid change in terms of skills and job security?

As much as most of us are thrilled not to be stuck in a job for 40 years, the thought of the job search, interview process and being the new kid on the office block all over again can leave you cold. Sayers says having the ability to change is a vital competency, as is learning agility, for the modern workforce.

According to Sayers, job security is not about continuing with the same employer, but having the confidence in yourself and your skills so that you can apply them in many roles and industries to match the emerging labour market. "View each job experience as building your career "portfolio" so that whatever direction you take, you can draw on and expand on these to achieve further success."

Got a problem?

Querulous queries on your rights in the workplace or unresolved issues with employees? Visit Melanie online at unlimited.co.nz/worklife or drop a line to melanie@unlimited.net.nz

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