Industry Canada Industrie Canada

# Self-Study Guide

# STEP 6:
# Identify Potential Investors


Canada

# STEP 6:
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# 6.1 Identify Potential Investors - Introduction

There's no shortage of financing out there. The challenge is finding it. Equity financing for small and medium-sized enterprises has become more common in recent years. If you've got a product or service concept that calls for lots of money to develop, there is a range of different types of investors to consider.

As you've seen in earlier Steps, building an investment proposal is a lot of work. All that effort can be wasted if your proposal doesn't get into the right hands. So, who should you send it to? We'll show you how to find investors, and once you do, target the right type of investor for your needs.

**In This Step**

In this Step you'll learn about the different types of investors, what they finance and how much money they want to invest. You'll get information about searching for investors and find some tips about how to find the best match for you.

- Decide Which Investors to Target
- What Type of Investor? What Type of Investment?
- Founders and Angels
- Corporate and Institutional Investors
- How to Look for Investors
- Where to Find Investors on the Web
- Match Investors' Criteria
- Assess Other Attributes
- Action Items

**The New Tech Story**

Follow the fictional company **New Tech Distributors Corp.** (New Tech) as it pursues venture financing. This case example gives you a feeling for the "real" data and strategic decisions you'll be facing.

# 6.2 Decide Which Investors to Target

Some investors prefer big deals; others prefer small ones. Some investors work with established companies; others work with start-ups. Some investors support one industry, such as high tech; others support many industries. Some investors prefer to be close to the business location; others don't care. You've got to weigh these factors before approaching a potential investor.

## Look for Common Ground

Sending your investment proposal to the wrong investor is like sending a steak to a vegetarian. Knowing the preference of each type of investor helps you decide which investors to focus on. In looking for investors to target, seek common ground in these areas:

| | |
|---|---|
| 1. **Stage of Development** | Does your business's stage of development match the investor's criteria? |
| 2. **Capital Required** | Does the amount you need fall within the investor's limits? |
| 3. **Industry** | Does the investor have a preference for specific industries? |
| 4. **Geography** | Is the investor located close to you? |
| 5. **Leadership** | If you're looking to syndicate your deal, will the investor consider taking a leadership position? |

Keep in mind, you're looking for more than money. You and the investor are looking to establish a relationship — maybe a partnership — that is mutually beneficial and ultimately profitable. Look for someone whose needs and interests match your own. Look for compatibility.

**1. Stage of Development**
It's important to approach risk capital investors who will be interested in the stage of development your business is in now (early stage, expansion stage or acquisition/buyout).

See section 6.3 for information on how different investors approach companies at different stages of development.

**2. Capital Required**
Investors will set upper and lower limits in terms of preferred investment size. Remember to distinguish between investment size and the deal size. An investor may take a piece of a large deal as long as the piece fits within the investor's limits.

Investors will also prefer certain types of investment vehicles. In the Canadian market, the types of deals break down this way: 39% common shares, 12% preferred shares, 15% subordinated debt, 11% debt with common shares, 12% convertible debt and 11% from other sources. (*Canadian Venture Capital Association*, 1997 statistics.)

**3. Industry**
Most equity investors will only invest in certain types of industries. Find out if your industry is one of them. If investors aren't interested, you'll avoid wasting time. If, on the other hand, investors are interested, they probably understand your industry. You stand to benefit from their experience, their valuable contacts and their ability to make quick decisions. And, you'll have an easier time getting your message across.

**4. Geography**
Geographic closeness is important to most investors, particularly those who want to be active in your business. Geographic distance is less important with larger firms where certain activities are centralized and local field representatives are easily accessible.

*Advantages to Approaching Local Investors*
There are certain advantages to approaching investors who live close to your business. First, through them, you may find other business contacts and sources of knowledge.

Second, it's easy for your investor to oversee the investment. Third, you may have the common objective of promoting local economic development.

**5. Leadership**
Certain investment firms are leaders; others are followers. If you're looking to syndicate your deal with many investors, you should approach leaders. These investors will take the lead and organize the syndication process for you. They will capitalize on their reputation and networking skills to bring together an investment team.

**Tip**
**Investors' Selection Criteria**

Selling your investment proposal is just like selling anything else. You need to qualify your investors before approaching them. You won't do your reputation any good by dropping your proposal indiscriminately on every investor's desk. An "over-shopped" reputation reduces your chances of attracting funds. Investors have their own networks and they talk to each other.

Try to learn about potential investors' investing patterns and criteria. Try contacting them; they're usually willing to share this information. Members of the Canadian Venture Capital Association (CVCA) and Réseau Capital publish their key criteria on their Web sites at http://www.cvca.ca and http://www.reseaucapital.com respectively. Or, contact the Business Development Bank of Canada (BDC) and ask for advice.

## 6.3 What Type of Investor? What Type of Investment?

Depending on your *business's stage of development* (see appendix), certain sources and types of financing are more common. Generally, projects in the early stages of development tend to be the riskiest. Then, as the product gets closer to being marketed, the lower the risk and the faster the profits can be realized.

| Stade d'évolution | Investisseurs | Type d'investissement |
|---|---|---|
| **Early-Stage Financing** | | |
| Seed | Founder Capital | Higher Risk/Higher Return |
| Start-Up | Founder Capital<br>Private Investors<br>Venture Capital Funds<br>Institutional Investors<br>Government-Backed Corporations<br>Corporate Strategic Investors | Equity |

| | | |
|---|---|---|
| **Expansion-Stage Financing**<br><br>Initial Expansion<br>Intermediate Expansion<br>Bridge | Founder Capital<br>Angel Investors<br>Private Investors<br>Venture Capital Funds<br>Institutional Investors<br>Government-Backed Corporations<br>Corporate Strategic Investors | Equity<br>Subordinated Debt |
| **Acquisitions and Buyouts** | Private Investors<br>Venture Capital Funds<br>Institutional Investors<br>Government-Backed Corporations<br>Corporate Strategic Investors | Lower Risk/Lower Return |

To learn more about the different types of investors, see:


- Section 6.4: Founders and Angels
- Section 6.5: Corporate and Institutional Investors


## Debt or Equity?

You, and your investors, must choose what type of investment is best for your circumstances. Of the two basic types of financing (debt and equity), risk capital investors generally prefer *equity* financing. Rather than placing their money in more traditional, safe investments (like mortgages, term loans, and so on), they look for growing businesses to invest in. Why? The reasons are varied. Some like to be more involved with their investments. They may enjoy the excitement and challenge of actively helping a young business grow. They may believe in the product or service. And of course, as you saw in Step 1, they are interested in the higher rate of return offered by this type of investment.

Some risk capital investment comes in the form of *subordinated debt*, in which the rate of return is affected by the performance of the company. Again, this type of investment offers higher rates of return than traditional ones, such as term loans.

**Tip**

- ***Debt*** financing means taking out a loan and paying interest on it.
- ***Equity*** financing means getting funds in exchange for selling or giving up a part interest in your business.

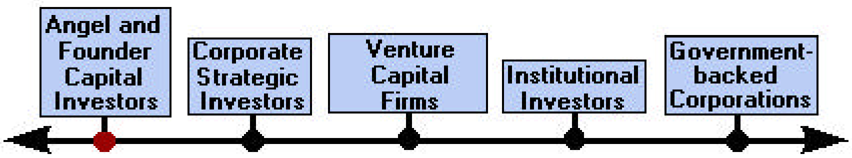
# 6.4 Founders and Angels

Early-stage investing often comes from:

- **Founder Capital** – you, the entrepreneur;
- **Love Money** – your family and friends; and
- **Angel Investors** – wealthy business people with contacts.

Also see section 6.5, *Corporate and Institutional Investors*.

**Level of Involvement**




**Active:**
• Plan
• Strategize
• Network
• Make Decisions
• Source

**Passive:**
• Monitor Investment
• Meet periodically

## Founder Capital and Love Money

You, as the entrepreneur, are considered a founder. The most logical place to look for financing is your own assets. These sources include money in the bank, certificates of deposit, shares and bonds, cash value in insurance policies, real estate, home equity and pension funds.

Love money investors are your family and friends. If you borrow from relatives and friends, make sure to spell out clearly the terms of the funding agreement (including the date, amount of the loan, interest rate, repayment schedule, collateral, signatures) to avoid future problems and disagreements.

***How Much They Invest***

Generally, the amount of money invested is small. Founder capital and love money are important at the earliest stage of your company's or project's development, a stage too risky for most other investors to back.

## Angel Investors

In general, angel investors are wealthy people, such as retired entrepreneurs and executives, who want not only to invest money but also to contribute their valuable business experience. Others are wealthy professionals, such as doctors or lawyers, who prefer to take a passive role in a business.

Angels bring much more than money to your business; they bring experience and know-how. They usually want to play an active role in your business. Their experience can work to your advantage if your management team lacks their kind of expertise.
Most angels want to see you invest plenty of your own money to make sure you're really committed.

Angel investors are hard to find because they don't advertise their willingness to invest. You'll typically need a referral from a financial advisor or other professional who has established contacts with these individuals.

***How Much They Invest***
Typical angel investors will invest between $25,000 to $250,000 in small and medium-sized businesses. Generally they provide equity financing and look for a return on their investment of about 30%.

**Tip**
Risk and reward are the venture capitalist's key concerns.

**How Investors Gauge Risk**
Every company, new or existing, big or small, has an inherent level of risk. At the early stages of a company's development, the risk tends to be highest. Generally, in its initial phase, a company has a promising but unproven product and needs equity funding to push it through to the next stage of development. In these circumstances, the risk is high and liquidity is low. As a company matures and begins to prove itself, the level of risk diminishes. For the company, access to capital improves; for the investor, the rate of return declines.

In risk financing investors share in the success, or failure, of a venture. Since there's a high level of uncertainty, investors will be interested only if the company shows a high return on investment - possibly as high as 40% or more a year. What's important to entrepreneurs is the low cash cost of equity investments. Investors generally make their money when they sell their shares.

## 6.5 Corporate and Institutional Investors

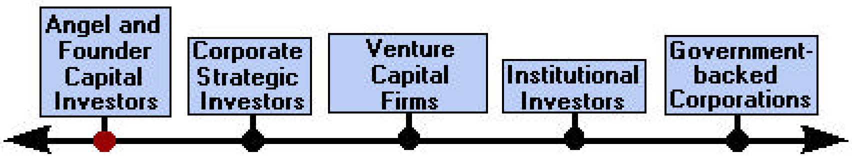
In recent years there has been a tremendous growth in the types of companies and institutions interested in risk financing. Risk capital investors include:

- **Venture Capital Firms** (e.g. labour-sponsored venture capital firms);
- **Institutional Investors** (e.g. pension funds and life insurance companies or their agents); and
- **Government-Backed Corporations** (e.g. Business Development Bank of Canada and others).

Another area that has developed is the strategic partnering by:

- **Corporate Strategic Investors** (e.g. major firms looking for partnerships).

**Level of Involvement**

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## Venture Capital Firms

Venture capital firms almost always provide funding for an equity or ownership in a business. They work primarily with existing businesses. The managers of venture capital firms are professionals with a vast amount of experience, contacts and business skills that can help your business become more profitable. Venture capital firms are looking for annual average returns of 30% to 40%.

These firms have particular preferences, strategies and investment criteria. Some firms will be interested in investing in the early development stage of a business. But most will be interested in companies involved in the expansion stage and the acquisition/buyout stages of development.

***Labour-Sponsored Venture Funds***
Labour-sponsored venture funds are one category of venture capital firms supported by the government through advantageous tax write-offs. These firms have emerged as dominant players in the private investment marketplace. Firms such as Working Ventures Canadian Fund, Fonds de Solidarité and Canadian Medical Discoveries Fund have significant amounts to invest. Some have the flexibility of investing in different regions of Canada while others are more interested in a particular province.

***How Much They Invest***
The size of their investment can range from $25,000 to $5 million. Although some larger firms will invest as much as $5 million, most investment deals range between $500,000 and $3 million, with firms setting minimum and maximum limits for their investments.

## Institutional Investors

Institutional investors include subsidiaries of commercial banks, investment banks, life insurance companies and pension funds. Canada has a wide range of such organizations including Bank of Montreal Capital, Royal Bank Capital Corporation, CIBC Wood

Gundy Capital, Penfund Partners, Investissement Desjardins, Roynat, Ontario Teachers' Pension Fund, OMERS and TD Capital.

***How Much They Invest***
Institutional investors provide equity and subordinated debt financing to small and medium-sized businesses. These organizations fund investments that are less than $1 million, as well as larger ones.

## Government-Backed Corporations

Government-backed corporations, such as the Community Futures Development Corporations, often provide equity financing in small communities where there are few mainstream investors. The Atlantic Canada Opportunities Agency supports businesses in the Atlantic provinces. The Business Development Bank of Canada (BDC), on the other hand, operates across Canada; BDC provides not only financing but also counselling, training and mentoring assistance.

***How Much BDC Invests***

- Venture Loans provides quasi-equity financing in the range of $100,000 to $1 million for expansion and market development projects.
- Working Capital for Growth provides financing up to $100,000.
- Patient Capital provides financing up to $25,000 for knowledge-based businesses in the early stages of development.
- Micro-Business Program provides training and counselling to very small companies, and up to $25,000 for new businesses and up to $50,000 for existing ones.

The BDC also offers term loans for expansion projects, plant overhauls, acquisitions and refinancing.

## Corporate Strategic Investors

Corporate strategic investors provide equity to small and medium-sized businesses. They differ from traditional venture capital firms in that their motivation extends beyond immediate financial reasons. Their business agreements are also referred to as "strategic alliances" or "corporate partnerships." Strategic investors have a wide range of objectives: to enhance innovation, to gain exposure to new markets and technologies, to find acquisition candidates, to assure sources of supply, to help a client, to initiate new ventures internally, and to spin off businesses that aren't appropriate for in-house purposes.

Their business arrangements fall into three broad categories.

- ***Partnering*** is designed to gain access to a product in less than two years. For example, a company is developing a software computer product that is compatible with the investor's existing production.

- ***Directed venturing*** is designed to complement long-term (two to seven years) development plans. For example, a corporation providing branch banking computer software programs may be interested in linking with an entrepreneur who is developing applications for Internet service providers.
- ***Corporate venturing*** is designed to protect territory for up to 20 years. For example, a corporate strategic investor wants to remain state of the art, to stay competitive and protect market share.

# 6.6 How to Look for Investors

The investment community is large, fragmented and dispersed. There's no simple way to find the money you'll need. Instead, you'll have to use personal contacts, investment professionals, industry and local organizations, libraries, business media and the World Wide Web.

The successful experience of one Canadian firm shows one way that the match can be made.

## Start Close to Home

Let people know what you're looking for. Network effectively. You should exploit, to the maximum, your business and personal acquaintances. Try to contact anyone who can give you meaningful introductions or referrals.

- Discuss your intentions with professionals who serve your business. Your lawyer, banker, accountant or financial advisor may be aware of investors. If not, they may be able to put you in touch with professionals who are active in investing.
- Join investor associations to expand your network and to find a mentor.
- Hire a financial advisor with expertise in venture capital.

## Expand Your Network

Valuable contacts can be made through:

- local Chambers of Commerce;
- industry associations;
- local and regional business development organizations; and
- investor associations.

## Look for Referrals

Use your contacts or approach known players in the venture capital market to get referrals and advice. You can always get their advice without soliciting their investment.

## Use the Media

Do a media search for news articles (again, your library can help). Follow reports of completed deals. Keep your eyes open for advertisements about investors showing an interest in investing.

## Consult Directories and Associations

Tap into your own industry or professional association for advice and information about how others in your field have grown and who helped them move ahead. And look into local sources of information — many municipalities now have entrepreneurship centres or economic development units that maintain up-to-date, accessible libraries of directories, associations, industry listings, business and other networks, and so on.

## Get Out in Front of Investors

Attend trade shows, conferences and investment forums. These are excellent venues for cultivating your network and developing contacts. Consider doing a presentation and setting up a booth at such events. It's a good opportunity for exposure and for advertising your business venture.

## Use the Web

The Web can be a great place to search for investors. See section 6.7 for some links to get you started.

**Tip**

**The Canada Community Investment Plan**

The Canada Community Investment Plan (CCIP) provides communities outside main financial centres with the information and tools they need to start and operate an investment facilitation service for their fast-growth small and medium-sized enterprises (SMEs). The best practices and lessons learned by 22 CCIP pilot projects are available on the CCIP website (http://strategis.ic.gc.ca/SSG/cw01100e.html).

**Tip**

For quick access to national, provincial and local organizations, try Industry Canada's information resource for small businesses: Contact! The Canadian Management Network (http://strategis.ic.gc.ca/SSG/mi03932e.html#types).

## Entrepreneur Stories

### Bfound.com Found an Angel

Bfound.com's owners found that finding the right investors can be a long process. But they used a local business development agency, some good self-promotion, a well-focussed investment proposal and perseverance to land their angel.

During Bfound.com's search for financing, management team members attended an industry trade show where they received a lot of interest and some good feedback, and were able to meet their competitors for the first time.

They worked with VIATeC (the Vancouver Island Advanced Technology Centre), a non-profit industry-led association to help identify possible investors. VIATeC suggested that they needed an angel since the company was lacking experienced management and focussed vision. Bfound.com's owners wanted someone who had been through the process of growing a company before — they didn't want love money; they wanted someone who could help.

The company prepared an executive summary outlining the investment opportunity. VIATeC filtered the angels for them to ensure that the company would be matched with someone who could help.

For the first round of financing, VIATeC circulated Bfound.com's Business Opportunity Document to three investors, one of whom was a good match.

**Entrepreneur Stories**

**Seeing and Being Seen: A Fictional Account of Finding Potential Investors**

Dorothy Doyle designs non-violent computer games, geared to primary school aged children. The games are fun learning tools. Her company is DD Games Ltd. Her products are quickly gaining exposure in local schools. These schools are prepared to endorse a number of the games and integrate the games into their curriculum. With this kind of support Dorothy is confident that she can market her product nationwide, if not beyond.

Recently, DD planned a nationwide marketing program to start one year down the road. This expansion plan was massive. DD Games needed a major cash infusion.

With her usual foresight, Dorothy began to nurture prospective investors well in advance. Dorothy wanted inexpensive exposure and the opportunity to network. She identified two scheduled computer software trade shows: one local and one out west. She bought booth space and got time slots to do a presentation. Dorothy diligently prepared for these two events. Her speech highlighted the growth potential, successes to date, the endorsements and ideas for new hot products. She prepared attention-grabbing visuals. She dubbed herself "Quarterback of a winning team." During her presentation, she tossed out souvenir footballs; printed on each was "DD Games."

Following these two events, Dorothy is now talking seriously to three potential investors who contacted her after her presentation. They are discussing the required capital, DD's targets and marketing plan.

## 6.7 Where to Find Investors on the Web

Here are just some of the many resources for finding investors on the World Wide Web. Web sites change and new ones spring up constantly, so be sure to repeat your searches every so often.

### Government Resources

- Industry Canada's Sources of Financing is a large, searchable database. (http://strategis.ic.gc.ca/sc_mangb/sources/engdoc/homepage.html)
- The Business Development Bank of Canada offers financial and consulting services for small and medium-sized businesses. (http://www.bdc.ca/bdc/home/Default.asp)

- Economic development organizations exist at the provincial, regional and local levels. Start with your provincial government's Web site or try Contact! The Canadian Management Network (http://strategis.ic.gc.ca/SSG/mi03932e.html).

## Venture Capital Directories and Associations

- Canadian Venture Capital Association (CVCA) provides a list of members, links to their sites, statistics and more. (http://www.cvca.ca/)

- Réseau Capital is the Quebec Venture Capital Association. (http://www.reseaucapital.com/index.html)

- Pratt's Guide to Venture Capital Sources (available in print at libraries and bookstores) is one of a number of venture capital directories. (http://www.ventureeconomics.com/newindex_p2.htm)

## Online Search Engines and Indexes

- Online search engines and indexes provide information or links to related Web sites. Here are just a few examples of where to start:

    - Excite Canada Small Business Venture Capital (http://www.excite.ca/business/small_business/venture_capital/

    - About.com's Investing Canada Venture Capital (http://investingcanada.about.com/aboutcanada/investingcanada/cs/venture capital/index.php)

- Try searching for "Venture Capital" on a Canadian search engine such as Yahoo Canada (http://www.yahoo.ca/) or Excite Canada (http://www.excite.ca/).

## Venture Capital and Investment Web Sites

This is only a small sample of the possibilities available on the Internet. These sites contain information, advice and links to investors. Some of them, such as Garage, operate like brokers.

- Capital Connection™ The Internet network of local databases containing business projects and venture capital sources. (http://www.capital-connexion.com/)

- The Canadian Business Exchange is a Canada-wide database for buying and selling Canadian businesses and finding investment opportunities. (http://www.canadianbusinessexchange.com/)

- Commercial Finance Online is a "Business Finance Search Engine." (http://www.cfol.com/)

- Garage.com is an online resource and venture capital broker. (http://www.cfol.com/)

## 6.8 Match Investors' Criteria

As you're identifying possible investors, keep track of their preferences and track record of investments. You want to pinpoint the very best matches for your company and, at the same time, ensure your company is the very best match for the investors you choose to approach.

Learn as much as you can about your prospective investors. They will each have key criteria for deciding what investments to make.

**The Investor Preferences Matrix**

| Criteria | Investor A | Investor B | Investor C |
|---|---|---|---|
| Stage of Development | | | |
| Capital required | | | |
| Industry | | | |
| Geography | | | |
| Leadership | | | |
| Total Score | | | |

Match up their interests and your company's characteristics by using a scoring system like this:

- 2 equals a good fit with your business venture;
- 1 equals a so-so fit; and
- 0 represents no fit.

Add up the points for each investor. Which investors are the best fit for you?

**Tip**
**Legal Implications**
Depending on the number, the nature, the degree of sophistication and other characteristics of your potential investors, you may be subject to certain legal and regulatory requirements. Before finalizing your investment proposal and contacting investors, you should seek the assistance of experienced legal counsel. Check out our Legal and Regulatory Overview in the Appendix.

**Take a Closer Look**
***See How It's Done***
Find out how our case example company, New Tech Distributors, was able to assess and rank potential investors. See section 6.3 of the Net Tech case story.

## 6.9 Assess Other Attributes

You should make a serious attempt to understand what makes your potential investor tick. Let compatibility and complementary styles guide you. Try to get a sense of the investor's psychological make-up. Did you know, for example, that some investors rely on their intuition when it comes to choosing a project? Here are some areas that you should check out.

- **Character, Reputation and Credibility —** Check out the investor's background.
- **Commitment and Staying Power —** Make sure the investor is committed for the long term.
- **Level of Involvement —** Find investors who will get involved to a degree that suits your needs.
- **Personal Chemistry —** Choose an investor whose style is compatible with yours.

Select your investors wisely. They will be your business partners. Consider their reputation, commitment, compatibility of goals, time horizon, flexibility and integrity. Be sure to ask potential investors the right questions when you make contact.

## Character, Reputation and Credibility

What kind of reputation does the investor have? Is this a person of integrity? Look at previous investment deals, the level of the investment, the size of company and the success factor. Talk to colleagues and professionals; learn what you can about the investor's background.

## Commitment and Staying Power

You want to make sure that your investor is firmly established and not facing any financial constraints. After all, you may need extra funds to deal with a future problem or take advantage of an opportunity.

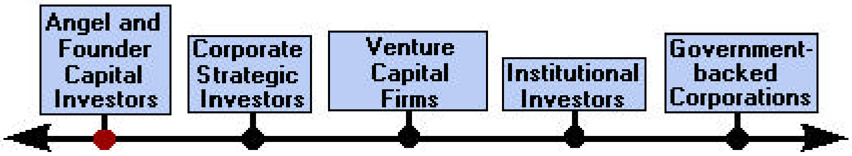
It often takes time to fulfill growth plans, so you want to make sure the investor is committed for the long term. Also consider whether your strategies are compatible. For example, what if you want to refine your product later on? Would the investor think you were getting carried away or go along with the idea?

## Level of Involvement

Some investors, typically angels, tend to take an active role in a business. Others, typically institutional investors, tend to take a passive, hands-off approach. Which type do you prefer?

If you're used to running your own business you may be reluctant to consider an active investor. Just remember, an active investor brings much more to a business than just money. This person can advise you on critical matters, take part in strategic planning, provide useful contacts and solve problems. Active involvement can also cement an investor's commitment to your business, which can be important if things go wrong. This diagram shows the general level of business involvement that you can expect from the various types of investors.

**Level of Involvement**




**Active:**
- Plan
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**Passive:**
- Monitor Investment
- Meet periodically

## Personal Chemistry

Do you and the investor get along well together right off the bat? Do you have similar ways of looking at things, make decisions in the same way, or have common interests? Sometimes, if the chemistry is right, private investors will invest in a project that doesn't fit their initial preferences. If your styles mesh, continue to explore the possibilities. Even if the investment doesn't work out, the investor may become an advisor to you, or a valued member of your network.

Finding a suitable investor is a lot like finding a marriage partner. You're looking for attributes that make for a good long-term relationship: commitment, mutual interests and trustworthiness.

## Key Questions

**Questions to Ask Potential Investors**

Before talking to prospective investors, develop a list of questions you would like to cover. Here are some you may want to work into your list.

- What role do you want to assume in our business? Do you intend to be an active or a passive investor?
- What is your decision-making process for approving capital expenditures?
- What type of restrictions would you want to impose on our business?
- Will you agree to a confidentiality agreement?
- Who will hold the rights to our technology (i.e. patents)?
- Are you dealing with our competitors (i.e. are there any conflicts of interest)?
- What restrictions and reporting requirements are you going to implement?
- Can you comment on your experience as an investor? Who are your contacts? Do you have any references?
- What deals have you completed in the past?

**Entrepreneur Stories**

**Investing Chemistry at Innov International**

Pierre Martin, founder of Innov International (a company that makes office furniture), was able to attract a private investor who had intended to invest in an agri-food company. Mr. Martin's enthusiasm for the project (and his solid background and contacts in the industry) convinced the investor not only to invest but also to become an active member of the management team. The chemistry was just right.

Mr. Martin and his associates got what they wanted — an active investor who could be a valuable resource to the management team by providing contacts and experience in addition to funds.

Mr. Martin and his partners found that private investors had fewer requirements than venture capital firms and funds. They also found that they preferred working with a board of directors composed of people who had invested their own money rather than representatives of venture capital funds. With private investors, you know who the directors will be and they are likely to be very frank — with funds, you don't know who the representative will be.

## 6.10 Action Items

Out of 100 entrepreneurs who look for risk capital, only 30 will be granted a meeting with a potential investor; and only one entrepreneur receives financing. How do you get to be that one?

In this Step you have seen that most investors have preferences about the ventures they fund, and they will be looking at how your company matches up with their criteria for becoming involved. You have also seen that, if you look for it, there is a wealth of information available to help you discover the investors that will be most interested in you. The more knowledge you have about possible investors, the better your chances of finding the right fit for your company.

The following checklist will help you to:

- assess your understanding of the ideas covered in this step;
- gauge your progress; and
- plan your company's approach.

## Checklist

| Activities | Status | Target Date | Responsibility |
|---|---|---|---|
| *1. Consider what kind of investor you should look for.* | | | |
| Determine what types of investors are interested in companies at your stage of development. | | | |
| Review your funding requirements to see how they match up with the profiles of various investor types. | | | |
| Decide what type of investor is best for you in terms of:<br>• industry experience;<br>• location;<br>• investment leadership, syndication; and<br>• level of involvement in management. | | | |
| *2. Find potential investors.* | | | |
| Use your own networks, professional groups or associations, business contacts, economic development organizations, and so on, to identify potential investors. | | | |
| Use professionals, such as financial advisors, lawyers and accountants with venture capital experience, to help identify prospects. | | | |
| Investigate online resources for identifying and linking up with appropriate investors. | | | |
| *3. Assess and rank the potential investors you have identified.* | | | |
| Get an understanding of investors' criteria, particular interests and previous track record of investments. | | | |
| Use a ranking system to match your needs with the potential investors' criteria. | | | |
| Choose the "best fits" for your company to approach. | | | |
| *4. Review your short list of prospects.* | | | |
| Prepare a list of questions you would like to ask potential investors. | | | |
| Do research, ask among your contacts or make personal contact with possible investors to learn more about them. | | | |
| Look into the reputation, level of commitment and personal styles of investors you are thinking of. | | | |

# Appendix

## Your Business's Stage of Development (see section 6.3)

### *Early-Stage Financing*

### Seed Financing

Seed/embryonic financing can cover preliminary research and development, developing a prototype, preliminary market research and patent or licence applications. It can include projects that need modest working capital financing.

### Start-Up Financing

Start-up financing is for companies completing product development and initial marketing. These companies may be in the process of organizing; perhaps they've been in operation for less than a year and haven't marketed their product commercially. These companies need money to fund a prototype or get involved in full-scale manufacturing and sales activities.

### Expansion-Stage Financing

*Initial expansion financing* is for companies with full-scale production and sales activities that haven't yet generated a profit. Since these companies are growing, they need funds to provide working capital financing for investments in accounts receivable and inventories.

*Intermediate expansion financing* is for growing, profitable businesses that need to expand their production to meet increasing sales volumes. These funds are used for expansion, marketing, working capital or product improvement.

*Bridge financing* is also known as interim financing. These funds are used to help companies go public within six to 12 months and to help finance underwriting costs and restructure existing stockholdings.

### Acquisition/Buyout Financing

*Acquisitions and leveraged buyouts* usually involve outside or third-party buyers who borrow money to buy a firm.

*Management buyouts* (MBOs) refer to transactions where a firm's own managers set up a new company and operate it. The equity comes from the managers themselves and from some funds and other institutions. Many MBOs originate to save the jobs of the purchasers and other employees. This situation arises when the parent company (the seller) decides an operation, division or subsidiary is no longer suitable and shuts it down or sells it.

## Tool – Legal and Regulatory Overview (see section 6.8)

**Overview of Prospectus-Exempt Financings: A Legal Perspective**

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**The issues addressed in this paper are complex and fact specific, and may vary in application from jurisdiction to jurisdiction. This paper is intended to provide only an overview of the concepts introduced here, and does not offer professional advice for any particular situation, nor does it address the issues completely or address all legal issues which may be related to the matters described here. The reader is urged to consult with an advisor who is knowledgeable in the area of the legal implications of conducting financings and, moreover, is familiar with the requirements of the specific provincial jurisdictions which apply to the offering.*

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**Introduction and Overview**

There are three fundamental principles of securities legislation: the efficiency of capital markets, the integrity of capital markets and investor protection. These principles are very much interrelated in that the integrity and efficiency of the capital markets are fostered, if not maintained, when investors are entitled to rely upon adequate and appropriate safeguards in making their investment decisions. The method and extent of these safeguards vary somewhat, depending upon the route taken by an issuer in gaining access to the capital markets. Under no circumstances, however, does the maxim "let the buyer beware" have any application. The questions, rather, are what is the appropriate gaining in the circumstances of the particular offering, and how to balance an investor's ideal wish for a guaranteed winner and the issuer's desire to raise capital without being exposed to liability in the event things do not turn out as hoped.

Securities legislation in Canada essentially provides three ways of distributing securities:

(a) pursuant to a prospectus which is filed with, and cleared by, the securities regulatory authority (typically a securities commission) in the relevant jurisdiction;

(b) by relying upon one or more statutory exemptions from the prospectus requirement (generically referred to as "private placements") in circumstances where the disclosure document, if any, is not required to be reviewed by the securities regulators (but is required to be filed); or

(c) by obtaining exemptive relief from the relevant securities regulator.

Securities regulation in Canada is a matter of provincial jurisdiction and, accordingly, each province of Canada has its own legislation regulating securities-related matters. Nevertheless, many of the principles and substantive provisions of the legislation in the various provinces are similar in approach.

*The Concept of Trading or Distributing Securities*

A "trade" in securities is defined broadly and includes any sale or disposition of securities for valuable consideration—but does not include a purchase of securities. In this way, the applicable securities legislation regulates the vendor of securities, but does not regulate the purchaser of securities. Trade is also defined to include any act, advertisement, solicitation, conduct or negotiation directly or indirectly in connection with a sale of a security. For the purposes of the applicable securities legislation, "distribution," where used in relation to trading in securities, includes a trade in securities of an issuer by that issuer (e.g., from treasury).

**Commonly Used Exemptions from Prospectus Requirements**

In describing a distribution of securities effected pursuant to a prospectus exemption, the term "private placement" is often used. While these different types of offerings are frequently referred to, collectively and generically, as private placements, the different prospectus exemptions result in different practical implications.

The policy behind certain exemptions from the prospectus requirements being permitted is that in certain situations investor protection does not require the detailed disclosure of the proposed investment or it's prior review by the securities regulators. This is frequently because the sophistication of the investor (or the "deemed" sophistication of the investor arising from the size of the investment) suggests that the investor does not "need to know" the information which would ordinarily be contained in a prospectus (i.e., that such an investor is in a position to dictate what protections are appropriate to, or necessary for, that particular person).

The use of certain prospectus exemptions can be beneficial for a number of reasons. First, the delay and the costs inherent in preparing a prospectus can often be prohibitive. Second, in certain circumstances a disclosure document may not need to be prepared. Third, even if such a document is required, the information to be provided in an offering memorandum is generally left to the discretion of the issuer and its counsel, provided that anything included or omitted does not amount to a "misrepresentation." Nevertheless, in some jurisdictions reliance upon certain prospectus exemptions necessitates the preparation of an offering document containing prescribed information.

Statutory exemptions are essentially self-policing, and each element must be reviewed to be satisfied that the issuer is entitled to rely upon a particular exemption. Since many exemptions are based upon the type of investor or facts which relate to the investor, part of this review typically includes obtaining statutory declarations or representations and warranties from the investor as to such facts. Issuers should not, however, blindly rely solely upon such declarations and representations (particularly if the circumstances of the situation suggest that the issuer knows or ought to know that they are likely to be incorrect), but should make reasonable enquiries and investigations to ensure that this reliance is appropriate.

*Private Company Exemption*

For very early stage financings where the promoter is relying exclusively on family, close friends and pre-existing business associates, one frequently relies upon the prospectus exemption under the applicable securities legislation which exists when one is issuing securities of a "private company" to persons who are not considered to be members of the "public" for the purposes of securities legislation. A "private company," which is defined more specifically in the particular province's securities legislation, is generally considered to be one which has, in its articles of incorporation restrictions on the transferability of its securities, a provision limiting the number of security holders to not more than 50 (not including employees and certain former employees) and a prohibition against inviting the publicto subscribe for its securities. There is generally no definition in the legislation as to which investors are considered to be members of the public for these purposes, and the courts and securities commissions have developed an extensive body of case law and precedent addressing the issue. A number of factors will be considered in making the determination, including the number of persons to whom the issuer tried to sell securities, the number of ultimate purchasers, the sophistication or investment expertise of the purchasers or their access to advice (including their capability to evaluate the merits and risks of the prospective investment), the net worth or ability of the purchasers to risk a complete loss of their investment, the relationship of the purchasers to the vendor, the manner in which the offering is made, the purpose of the offering and the circumstances relating to the vendor. In many cases, the courts and securities commissions have applied the "need to know" rule, whereby they consider a person not to be a member of the public if he or she does not need the type of knowledge about the issuer and the security ordinarily available in a prospectus. No one of the foregoing considerations will be determinative but, rather, the overall circumstance will be evaluated. The determination of who is or is not a member of the public is plagued with uncertainty, and the ultimate determination will be based upon a review of the salient facts—which determination and examination will always be viewed in hindsight often having regard to the views of the judge or the regulators as to whether protection should be extended to the investor.

If an investor is considered to be a member of the public (and, therefore, entitled to the more detailed protections of securities legislation), the trade to such person must be conducted in a manner which allows it to be exempt from the general prospectus requirements of the applicable securities legislation.

*Seed Capital Exemption*

The "seed capital exemption" is generally used in the relatively early stage of financing of companies in circumstances where the private company exemption is considered to be unavailable (because, for example, the offering is being made to members of the public). The applicable securities legislation should be reviewed to determine the specific eligibility criteria, including whether there is a minimum subscription required (which, for example, under a specific exemption in the British Columbia legislation, requires a minimum subscription of $25,000), whether a specified form of offering document must be prepared, the number of persons to whom an offer may be made, the sophistication requirement of the purchasers, the number of persons who may purchase in reliance upon the exemption and the period of time during which the offering may be made. For example, in Ontario some of the conditions imposed under that province's securities legislation are that:

> (a) solicitations may be made to not more than 50 prospective purchasers and result in sales to not more than 25 actual purchasers, each of whom must purchase as principal (such numbers being in respect of solicitations and sales in all jurisdictions, including Ontario); and
>
> (b) each purchaser must have "access to substantially all the same information concerning the issuer that a prospectus" filed under that province's securities legislation would provide and must either be:
>
>> (i) an investor who, by virtue of net worth and investment experience or by virtue of consultation with, or advice from, a person who is not a promoter of the issuer and who is a registered advisor or a registered dealer, is able to evaluate the prospective investment on the basis of information respecting the investment presented by the issuer; or
>>
>> (ii) a senior officer or director of the issuer, or the parent, brother, sister, child or spouse (common-law or otherwise) of a senior officer or director.

Clearly, the policy behind the seed capital exemption is that an investor who is sophisticated, as evidenced by net worth, business experience, independent advice or close personal bonds of association with the issuer, is deemed to be capable of protecting his/her own interests and, by implication, is not in need of the same kind of investor protection as other investors.

*Minimum Subscription Private Placement Exemption*
The private placement exemption which is frequently referred to specifically as a "private placement" is based upon a minimum amount of the securities purchased by the investor which, depending upon the particular jurisdiction, varies from $97,000 to $150,000. Since it may be relied upon any number of times without a specific need for the investor to be provided with, or even have access to, any documentation or information, it is one of the most popular exemptions available. Under the applicable securities legislation, the only qualification of the exemption that generally applies is that the purchaser must purchase, as principal, securities having an aggregate acquisition cost of at least the specified amount. Certain securities commissions are of the view that neither corporations or syndicates, nor partnerships or other forms of unincorporated organizations should be created solely to permit purchases by groups of individuals whose individual share of the aggregate acquisition cost is less than the specified amount.

**Disclosure Considerations: Documents and Concerns**

*Exempt Offerings: Offering Memoranda*
There are no requirements governing disclosure documents for use in connection with securities issued in reliance upon the private company prospectus exemptions. Moreover,

no filings must be made with applicable securities regulators in respect of such financings.

Written material delivered to investors in connection with the seed capital exemption and the minimum subscription private placement exemption will frequently constitute an "offering memorandum" for the purposes of the applicable securities legislation. Business practice often dictates that comprehensive material be prepared for delivery to prospective investors to induce them to acquire offered securities. Each province's securities legislation should be reviewed to determine what the specific requirements within that province are as to the need to prepare an offering document and what, if any, are the required contents of such a document. Moreover, the specific legislation should be reviewed to determine what, if any filings must be made with, and fees paid to, the applicable securities regulator as a result of the financing.

For the purposes of the Ontario securities legislation, for example, an offering memorandum is a document which:

(a) purports to describe the business and affairs of an issuer;

(b) has been prepared primarily for delivery to and review by prospective investors to assist those investors in making an investment decision; and

(c) is prepared in connection with a distribution being conducted in reliance on particular statutory prospectus exemptions, including that province's $150,000 private placement exemption and the seed capital exemption.

A document does not need to be identified as an offering memorandum in order to be treated as such for the purposes of the applicable securities legislation. It could be identified as business plan or an investment proposal or otherwise. Technically, each separate document which fits the foregoing definition constitutes an offering memorandum for the purposes of the Ontario legislation (or, at least, all documents taken together will constitute an offering memorandum). Excluded from the definition of offering memorandum are documents setting out current information about an issuer for the benefit of prospective investors "familiar with the issuer through prior investment or business contacts." Also excluded from the definition, in certain cases, are the annual reports, information circulars, prospectuses and other documents the contents of which are prescribed by statute or regulation. These exceptions will not be discussed here.

When a security is distributed in conjunction with an offering memorandum in reliance upon the Ontario $150,000 private placement exemption or the seed capital exemption, it is generally required that the purchase be given a contractual right of action for rescission or damages in respect of any "misrepresentations" contained in the offering memorandum. These rights are to be described in the offering memorandum and generally correspond to those which a purchaser of securities under a prospectus would have. Moreover, in situations where one is relying upon the seed capital exemption in Ontario, the Ontario legislation requires that the investor have access to substantially the same information concerning the issuer that a prospectus filed under the Ontario securities legislation would provide; this is frequently satisfied by including such information in an offering memorandum.

In some jurisdictions outside of Ontario, the legislation prescribes what must be contained in an offering memorandum delivered in reliance upon certain of the prospectus requirements in such legislation. Neither the Ontario securities legislation nor the Ontario Securities Commission prescribes what an offering memorandum should contain. Given the self-policing nature of offerings pursuant to the seed capital exemption and the private placement exemption, such a decision is thought to rest more appropriately with issuers and their advisors.

The prohibition on an offering memorandum containing a "misrepresentation" implies, having regard to the definition, that the offering memorandum cannot:

(a) contain an untrue statement of a material fact; or

(b) omit a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made.

The term "material fact" means a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of the securities being offered. Accordingly, once a decision is made to deliver an offering memorandum to prospective investors, it cannot contain only selective information. One cannot, for example, merely highlight the positive aspects of the issuer's business or deal only with certain areas of the business.

Clearly a prospectus standard of disclosure is not required in the offering memorandum, and something short of that is acceptable. Nevertheless, it is not unusual to find that the offering memorandum frequently resembles the format and appearance of a prospectus for practical, although not legal, reasons.

While the securities legislation does not provide that an offering memorandum be reviewed by staff at the applicable securities commissions, there is often a requirement that it be delivered to the securities commissions after completion of the offering.

It should be recognized that the legislation does not contemplate delivery of a draft offering memorandum. Each document (or version thereof) delivered to each investor (including various versions of the offering memorandum) constitutes an individual and separate offering memorandum which must include a contractual right of action.

**Use of Future-Oriented Financial Information**

It is not always necessary or appropriate to include in the offering document future-oriented financial information (FOFI) consisting of forecasts or projections. Nevertheless, the securities regulators have established a FOFI policy with respect to the inclusion of FOFI in certain specified types of offering documents. The FOFI policy is not generally considered to apply where the offering of securities follows the private company exemption.

A "forecast" is essentially FOFI prepared using assumptions which reflect the issuer's planned courses of action for the period covered, given management's judgment as to the most probable set of economic conditions. A "projection," by comparison, is FOFI prepared using assumptions that reflect the entity's planned courses of action for the period covered, given management's judgment as to the most probable set of economic conditions, together with one or more hypotheses (i.e., assumptions that assume a set of economic conditions or courses of action that are consistent with the issuer's intended course of action and represent plausible circumstances).

The policy relating to FOFI specifies the manner in which FOFI may be prepared, disclosed, pre-cleared, dated and subsequently compared with actual results, and also addresses the involvement of auditors with such documents. The FOFI policy applies to disclosure documents such as prospectuses and to offering memoranda prepared for use in connection with the seed capital exemption and the private placement exemption, but does not apply to offerings where the minimum acquisition cost under the offering memorandum is at least $500,000.

The requirements of the policy in connection with the preparation of FOFI are implicitly a list of why many issuers may find that they may not effectively rely upon FOFI in connection with their offerings. Among the requirements are the following.

> (a) FOFI shall be in the form of a forecast. Notwithstanding this, projections may be used for issuers engaged in a business with less than 24 months of relevant operating history or in certain other limited circumstances. A forecast or a projection may be used, but not both.
>
> (b) The period covered by the FOFI shall not extend beyond the time for which such information can be reasonably estimated (normally the end of the next year i.e., a maximum of 24 months).
>
> (c) FOFI prepared in accordance with the FOFI policy must be prepared in accordance with the CICA Handbook together with any additional requirements in the policy.
>
> (d) The need to pre-clear FOFI with the securities commissions in a province prior to filing a preliminary prospectus varies from province to province. Frequently, the requirement to pre-clear before the preliminary prospectus is filed only exists in connection with an initial public offering or in circumstances where an issuer is conducting its first public offering in the particular province. Otherwise, the FOFI is reviewed after the preliminary prospectus is filed and during the normal review process for the remainder of the preliminary prospectus.

(e) FOFI must be accompanied by an auditor's report, which shall not contain any reservations of opinion.

(f) The FOFI policy provides that FOFI (other than FOFI in an offering memorandum) shall be reviewed each time the issuer is required to file historical financial statements with the securities commission under its continuous disclosure requirements (i.e., both quarterly and annually) to identify material changes resulting from events that have occurred since it was issued. The FOFI policy also deals with updating the FOFI when a change occurs in the events or in the assumptions used to prepare FOFI that has a material effect on such FOFI. The securities regulatory authorities must approve of the withdrawal of FOFI when it is not being replaced by updated FOFI.

Most companies do not necessarily have expectations that their financial results will be particularly impressive within the 24-month period which is generally the outside date for the FOFI. As a result, the use of FOFI is not generally practical for use by such issuers.

**Statutory Liabilities**

*Criminal Liability*
The Criminal Code of Canada provides that every one who, "by deceit, falsehood or other fraudulent means," defrauds the public or any person, whether ascertained or not, of any property, money or valuable security is guilty of an indictable offence and on conviction is liable to imprisonment for 10 years where the value of the subject matter of the fraud exceeds $1,000 and lesser penalties where the value is under $1,000. The Criminal Code of Canada specifically provides that every one who, "by deceit, falsehood or other fraudulent means," affects the public market price of stocks, shares, merchandise or anything that is offered for sale to the public, is guilty of an indictable offence and, on conviction, is liable to imprisonment for a term not exceeding 10 years.

*Quasi-Criminal Liability*
The securities legislation of certain of the Canadian provinces provides that a director or officer who "authorized, permitted or acquiesced in" certain activities, including a breach by an issuer under the legislation (such as the issuance of securities without the preparation of a prospectus in circumstances where a prospectus exemption was not available), commits an offence and, on conviction, is liable to a fine and imprisonment. In Ontario, for example, the fine is up to $1,000,000 and the imprisonment is up to two years, or both.

**Conclusion**
At some stage in a company's development, it will likely be necessary for the founders to seek additional funding for the company's operations by attempting to get access to the capital markets. Securities regulation generally presumes that an offering of securities by an issuer must be made pursuant to a prospectus unless an exemption from the prospectus requirement is available. This paper has outlined some of the considerations for an issuer pursuant to an offering by way of private placement. The method by which the issuer

gains access to the capital markets and the types of prospectus exemptions which are relied upon will have a dramatic impact upon the requirements which are imposed upon (and the issues which should be addressed by) the issuer and its senior officers and directors before and during the offering, as well as on an ongoing basis.