

Morgan Stanley

Connecting to Capital

The article from a few weeks ago shared the importance of creating a supply/demand imbalance in your favor when raising capital for your company. This time we will address one of those methods: how to approach capital sources, mainly venture capital firms (VC's), private equity groups (PEG's) and family offices (FO's). The Davis/Yost Group at Morgan Stanley Private Wealth Management helps with growth raises, recapitalizations and exits. The smaller companies we assist in raising growth equity typically at least have a proven business model evidenced by recurring and growing revenue, so they are often beyond the level of angel investors and ready for the larger investors mentioned above.

First, connect with capital outside of north Texas. A January 7, 2019 report from Crunchbase about the global VC market stated that, for the first time ever, VC dollar volume from China exceeded the U.S. in the second quarter of 2018.ⁱ Narrowing it down, a U.S. News & World Report listed Texas as fourth in the country for venture capital dollarsⁱⁱ; however, an additional Crunchbase report from January 10th showed that over half those dollars went to Austinⁱⁱⁱ. The point is that there is much more opportunity for deals outside of north Texas; and I see many capital providers searching outside of north Texas for companies, so companies seeking capital should do the same. Some entrepreneurs with previous successful exits may have built credibility and connectivity outside of north Texas, so this may not apply directly to them.

Second, when an entrepreneur says they are talking with a potential investor, I usually ask, "Did they call you or did you call them?" Investors are actively seeking opportunities not represented by an investment banking firm and the reasons are multiple, but all get down to avoiding competition from other investors. Therefore, when taking those calls, remember the following:

- It's a fair assumption that the investor sees more pitches than you, and can pick apart your pitch deck if it's not prepared by someone who knows what the investor wants to see.
- It's also a fair assumption that the investors' attorneys are more experienced than yours.
- It's also a fair to assume the investor has more experience negotiating deals than you do.

There are great companies across the U.S., many of which are represented by investment banking firms with access to potentially hundreds of investors. They have an opportunity to create competition for their equity, moving the supply/demand line in their favor.

When the entrepreneur makes first contact to the VC/PEG/FO, there is an immediate “positioning” that occurs where the investor is in the position of power, and the business owner is in the position of need. This can be muted, or even reversed, if a contact in between connects company and investor; however, relying on friends, colleagues and contacts to make those connections can put the company into the same position of weakness. Additionally, multiple uncoordinated contacts can lead to the same investor being approached multiple times, making the company look desperate or the deal “stale.”

Early capital raises can impact later fundraising rounds. For instance, existing investors don’t like raising capital at a valuation lower than the previous raise (a “down round”). Also, giving up too much equity in early rounds can dilute an owner’s upside when the final liquidity event occurs. Which investors get involved early can impact which investors get involved later. Therefore, don’t go into a raise without being prepared and accompanied by experienced partners.

I’ve been around the north Texas startup community for six years, and the largest complaint I hear is regarding the lack of early-stage capital. The capital for proven companies ready to scale is out there, but understand first, how to find it and second, how to approach it. It’s about supply and demand.

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ⁱ <https://news.crunchbase.com/news/q4-2018-closes-out-a-record-year-for-the-global-vc-market/>

ⁱⁱ <https://www.usnews.com/news/best-states/articles/2018-05-10/4-states-control-80-percent-of-venture-capital-dollars>

ⁱⁱⁱ <https://news.crunchbase.com/news/austin-retains-crown-as-king-of-texas-vc-in-2018/>