FP EDGE

FE1 FINANCIAL POST, MONDAY, OCTOBER 6, 2003

Table talk

Many families can't work together at the kitchen table. Why should colleagues have to? Page FE2

ENTERPRISE: SMALL AND MID-SIZED BUSINESSES

Angels are not tooth fairies

MUCH MORE THAN FUNDING

A good investor will mentor – and hold your feet to the fire

By Tony Wanless

Some straight talk from Haig Farris should be a balm on the wounds of Canadian technology and knowledge-based businesses caught in the thorny struggle to find financing in the hostile post-tech-bubble climate.

A classic angel investor — often considered the dean of angel investors in Vancouver — Mr. Farris is a technology/venture capital entrepreneur who helped build companies for 35 years and still relishes putting some of his money and time into promising early-stage ventures.

"Market opportunities and novel technologies come and go, so at the end of the day you rely on people to navigate change and create success," Mr. Farris observes. "If you back people of extraordinary intelligence and integrity, act as a mentor, and occasionally hold their feet to the fire, they go to the end of the Earth to create success for their company and its stakeholders."

Mr. Farris' words come at a time when increasing numbers of small businesses in the early or startup phases and desperate for financing are finding themselves on the doorsteps of angels. These investors — the earliest-stage players in the private-equity food chain — are usually individuals who have made money through entrepreneurship and now want to reinvest in other enterprises.

Most are in it for the returns and are willing to take more risks than your average investor. Many are equally driven by a desire to put their experience and Rolodexes to work to help build the next generation of successful companies. Angels often take an active role with companies in which they invest, but also keep a pretty low profile so they won't be deluged with pitches.

"Angels don't hang out a shingle looking for deals — we find and co-operate on deals within a local network of trusted contacts that includes entrepreneurs, angels and early-stage venture funds that can together successfully take a company from concept to market leader," Mr. Farris says.

However, a number of angels have come out of the shadows in recent years, gathering in organizations such as the Vancouver Angel Network, Band of Scoundrels and Purple Angels in Ottawa, and the Calgary Angel Network — all hot cities for angel activity.

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PETER REDMAN / NATIONAL POST

Quick on the draw: Richard Reid, left, and Jim Ambrose, of Argosy Partners, sometimes help with private equity financing in crisis situations.

Merchant bank ventures where traditional financing hesitates to go

Shotgun showdown

By Jim Middlemiss

Michael Desnoyers had come to a crossroads with his partner in the spring of 2000 and was ready to toss in the towel on Etratech, the successful electronic design and manufacturing company they had built in Burlington, Ont.

"I was comfortable with my view of the strategic direction the company should take. My partner wanted to go in a different direction, which in my opinion was damaging the company overall," he explains. So he approached his partner with a plan that would move Mr. Desnoyers out of the company. However, things rapidly deteriorated and it became like a "bad divorce."

Fortunately, his shareholder agreement included a shotgun clause, designed to allow business partners to settle their disputes once and for all. Under the agreement, one partner could put a price on the table for the value of the business and it was up to the other partner to take the money or match the offer. His partner pulled the shotgun and rather than take the money, Mr. Desnoyers decided to stay and fight for what he had helped build. The challenge, however, was finding someone with the capital to allow him to buy out his partner's share of the business within the 30-day deadline stipulated in the shotgun — no easy task.

While he had approached GE Capital, officials there told him it would take 60 to 90 days for a decision. Luckily for Mr. Desnoyers, his accounting firm had recently attended a seminar where shotgun clauses and financing options were discussed. He was quickly put in touch with his private equity white knight, Argosy Partners Ltd., a Toronto merchant bank run by Richard Reid and Jim Ambrose.

Within 48 hours, Mr. Desnoyers had a financing commitment that allowed him to buy out his partner.

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DON'T BE SHY ABOUT ASKING GOVERNMENTS FOR FUNDING

GEOGRAPHY COUNTS

By Bev Cline

Entrepreneurs looking for financing need to think beyond a bank or credit union. The keyword should be geography. Whether your company is in Cape Breton, or Vic toria, there may be government programs designed to boost the local economy by investing in small and mid-sized companies.

Trout River Industries (www.troutriverindustries.ca) in Coleman, P.E.I., reaped the benefits of looking for startup financing close to home. Founded in 2002, the 11-employee company develops and manufactures conveyor-bottom trailers designed to safely unload asphalt and other earthen products.

"We received a loan of close to $100,000 from West Prince Ventures Ltd., the local Community Business Development Corp. (CBDC)," says Matthew Brown, who launched the company with his neighbour Harvey Stewart.

"We are not replacing existing jobs. We are creating new ones in our area, which has typically suffered from high unemployment.

'IN A RURAL AREA, ANOTHER HANDFUL OF JOBS MEANS A LOT'

This is an area with an agricultural history and dependence on fishing. Development hasn't tended to come to western P.E.I."

In rural Atlantic Canada, there are 41 CBDCs, sponsored by the federal government. "Local decision-making is the cornerstone of the program," says Basil Ryan, chief operating officer for Atlantic Association of CBDCs. "The impact on the community is a prime consideration, along with basic business planning criteria, in the lending decision."

CBDCs are "patient lenders," often funding companies that may not have equity or security, but whose potential success will have a beneficial effect on their area.

Mr. Brown forecasts Trout River Industries, which sells its units throughout Atlantic Canada and has recently broken into the Ontario market, has the potential to ramp up to 16 or 20 employees in the next two years. "We're not talking big numbers in the short term," he admits, "but in a rural area like ours another handful of jobs means a lot."

Here is how to get started:

Don't be shy The experts say you need to ask about geographical funding programs in order to be eligible for them. "When entrepreneurs call in and ask about financing, one of the criteria we use is definitely geography," confirms Eugene Sandhu, contact centre manager for the Canada-Ontario Business Service Centre in Toronto.

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Banks support good managers

THE BOTTOM LINE

Having cash flow will get businesses through a downturn

BY JIM MIDDLEMISS

When it comes to managing a business, the bottom line is not how much revenue the company generates — just ask any banker or accountant. Managing a business is about cash flow and managing the money that does come in.

"One of the things entrepreneurs struggle with is they don't understand the difference between profit and cash flow," says David Cook, a chartered accountant at KPMG LLP in Toronto. "You can be profitable and not have cash flow," and vice versa.

The first thing a bank looks for is cash flow. Security and management are second and third on the list. Often, problems can be identified early if owners simply pay more attention to cash flow. Knowing their cash position helps company owners avoid problems or develop contingency plans if a cash squeeze is on the horizon.

So here are a few tips for managing cash flow:

Budget better "Clearly you don't see enough companies budgeting or projecting their cash flow," says Ray Wheeler, a chartered accountant at Grant Thornton LLP in Toronto. "They should be doing it on a weekly basis. That way you know what's coming and know what you need and are likely to collect." If firms are current in terms of projections, they can normally handle any hiccups. He urges owners be realistic in their projections — too much optimism can come back to haunt them.

Unlock inventory One of the best ways to improve cash flow dramatically is to improve inventory management, Mr. Cook says. "We call it locked-up cash. It's sitting waiting to be crystallized." To do this, companies must know what sells and the life cycle of products on their shelves. He suggests ranking inventory in four categories: The A stuff has fast turnover, things "everybody wants"; the B items are good products that sit around for no more than 30 days; C things are "getting old and dusty" and D are the "dogs and duds you write off." The trick is to buy A and B items and stop trying to sell C and D stuff.

Bill and collect While some clients might appear attractive because they offer large distribution markets, there are trade-offs, Mr. Wheeler says. They will likely squeeze a firm's margins and string out payments. "[Most companies] don't have the strength to stand up to notorious slow-paying companies." He says many companies must pay in 30 days for materials to make a product, but it takes them 60 to 90 days to collect payment once the product is shipped. It is important to be on top of billings and collections, otherwise "you could get caught in a squeeze," he says.

Mr. Cook adds, the faster companies bill, the sooner they collect: have systems in place that allow you to "get invoices out more quickly, and you'll get paid more quickly."

Keep cash in the company A problem smaller companies face is that owners "want to strip out any excess profits," Mr. Wheeler says. They bonus out money in a bid to manage their tax bill, he says. The problem arises when the owner leaves no equity in the company, and things go sour, then there is no buffer for the company to ride out a downturn. "There's nothing to fall back on," he says, and banks might get cold feet, and shut off the capital valve.

Build a cash culture Finally, the experts say, cash flow management starts at the top. Michael Howe, a chartered accountant at KPMG, says "To manage your cash flow effectively you're going to have to indoctrinate a culture of cash." Remember it is middle level management, not the chief executive or chief financial officers that are going to be on the front lines making the collection calls and doing the billing. It is imperative those managers understand how "important their position is and that they make it happen."

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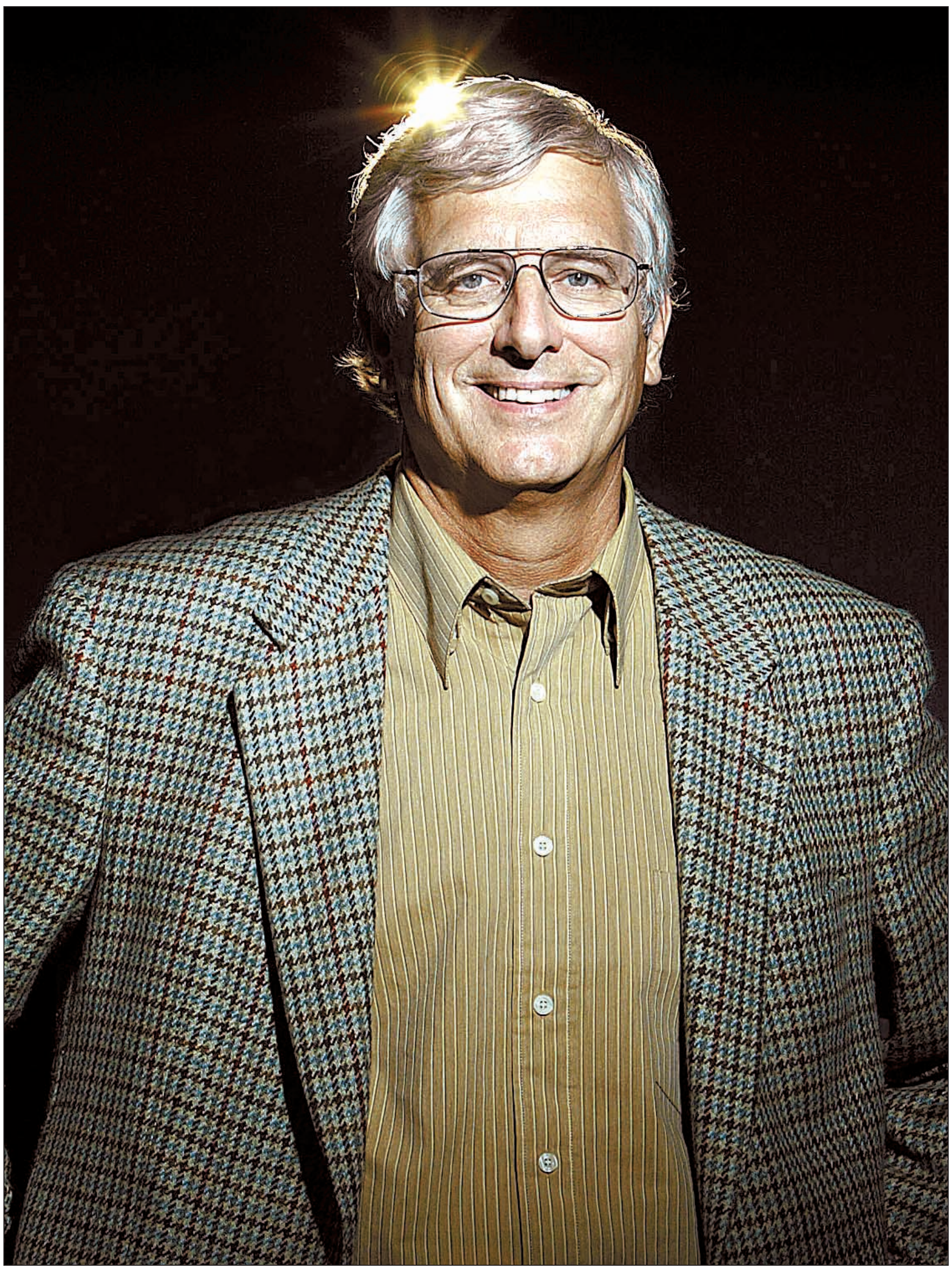
About 5,000 companies in Canada will fall into a funding gap between love money and venture capitalists, and that is where angels come to the rescue



LYLE STAFFORD / NATIONAL POST

Haig Farris relishes put time and money into start up tech firms with potential, but he knows there are few people who do.

Calling all angels

INVESTOR

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About a year ago, the National Angel Organization (NAO) was formed in Toronto to bring best practice and other information to angels across the country.

Other players in the investing game such as venture capital funds (VCs) and banks now recognize the place of angels in the investing pantheon. That recognition has created an investment chain: The best angel-backed deals are the feed-stock for early-stage venture capitalists; the best venture capital deals are the future feed-stock for the bankers.

Henry Vehovec, NAO president, says at least 5,000 companies in Canada fall into a funding gap between love money — initial funding from family or friends — and venture capital. That gap, he says, could easily be as much as $5-billion.

"Most of these companies are small, probably 10 or less employees, and form the heart of innovation in Canada" he says. "Yet, there is a genuine crisis in early stage capital formation in this country. If we could harness the cumulative finances of high net-worth people into risk capital [read angels], we could be the most innovative country in the world."

This growing angel culture in Canada does not mean that just any old company will be funded, however. Angel investors may be risk takers, but they are experienced company builders and are far from reckless. They like solid business potential and talented founder teams in their investee companies.

"The sweet spot for most angels is where a company is about to have revenue, or at least be within shouting distance of it" says Bob Chaworth-Musters, an NAO director and long time organizer of forums that bring together companies and investors. "Concepts don't get funded any more, and development sometimes does, but not often."

The way it works is angels invest very early in a company's life when its value is very modest. If the company hits its milestones, its value increases and it becomes attractive to VCs who back the next stage of growth.

While the valuation step-up between rounds of financing is attractive on paper, any gain for the angels and the VCs remains illiquid until the company is either sold or taken public. It is a very long-term game, not for the impatient or the risk-averse, but for investors who know what they are doing it can pay returns of upward of 10 times the initial investment.

"I think my best hit is about a 55-times return on my investment," Mr. Farris recalls. "The wealth created in that company has generated some new angels in town and the cycle continues."

Angels need early-stage VCs with capital and expertise as a graduation point for their deals. But as established VCs in Canada get bigger, the gap between where angels leave off and big VC funds get interested has widened.

This has made for closer relationships on early-stage deals between the angels and a new breed of boutique VC funds. For example, Vancouver's Yaletown Venture Partners recently attracted $30-million into its inaugural fund from a combination of major institutional investors and several of the most respected technology angels for investing in early-stage information and energy technology companies in Western Canada.

"We bridge the gap between where angels leave off, and larger, later-stage venture funds begin to get interested" says Steve Hnatiuk, co-founder of Yaletown. "In our market, there is a funding gap for promising angel-backed companies seeking between $1-million and $3-million in a first professional investment round. This is precisely the stage where we get very interested in the deal."

Companies looking for angels need to consider several things before they begin their search, says Leonard Brody, an entrepreneur who helps companies find money and co-author of *Innovation Nation*, a study of Canadian business innovation practices.

He says companies need to answer a few questions first: Do they need it? (which incorporates whether the industry has room to grow); Can we afford it? (there are many chores to perform before a company can begin searching for capital); Do we know how to get it? (raising angel money is a delicate art form involving much negotiation over structure and involvement).

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Funding can come from more than one level of government

COMMUNITY

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"If your company is located in Northern Ontario, for example, I might direct you to a program that specifically serves your area. Or I might direct you to your local municipality, which may have money to help with expansion financing," Mr. Sandhu says.

"Sometimes we can direct you to a number of sources from many levels of government and these could possibly be combined with private financing."

In some cases, accessing this financing may hinge on pulling up stakes and moving to a new locale. "If you are flexible about where you locate your company, there may be sources of financing that are not available in your present location," he advises.

Surf the Web Entrepreneurs can also go online to find information. Here are a few Web sites that offer information in both official languages:

▮ www.strategis.gc.ca/sources: Billed as the Sources of Financing Web site, it provides a lot of listings and links to organizations that offer financing for startup or expansion funds. Sources range from large-scale investments to microfinancing. It is an easy-to-use site that lets you access many geographically specific sources (federal, provincial and municipal). It also provides links to private and private and public initiatives geared to specific communities.

▮ www.cbsc.org: At the Canada Business Service Centres site, visitors click on a provincial or territorial flag to visit the Canada Business Service Centre in their area. Then they can do a combined search of federal, provincial and/or territorial information. A Talk to Us Live! feature lets visitors talk with a business information officer by phone as they search the Web together. Vistors can search other communities, or provinces, for financing, too. If entrepreneurs are flexible as to where they locate their company it may be easier to secure financing.

▮ www.communityfutures.ca: The Web site of the Pan Canadian Community Futures Network is a gateway to nearly 300 Community Economic Development Centres across Canada. The site has links to every province and territory. For example, it links to the Community Business Development Corporations in Atlantic Canada and the Community Futures Development Corporations in Western Canada.

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FAMILY TIES DO NOT BIND IN CASE OF LOANS

LOVE-MONEY AGREEMENTS

BY EILEEN P. GUNN

Eric Martin began to think seriously about starting his own business last New Year's Eve when he was told Gallerani's Cafe, where he had been keeping the books and playing host for two years, was closing. The real inspiration came from a couple who had been coming into the Provincetown, Mass., restaurant for years. "The wife got teary-eyed," Mr. Martin says. That was his first inkling he could count on loyal customers.

Getting the space (a 100-seat restaurant) was easy; getting the capital was considerably more difficult. When the funds he and colleagues pooled to open Jackson's, a steak and seafood house, fell US$5,000 short, he began looking to friends and family. Topping the list were Anita Butler, the teary-eyed regular, and her husband, David. "I started off the conversation with the Butlers by saying it's hard to borrow money from friends," Mr. Martin says. To reassure Mr. Butler everything would be kept professional, Mr. Martin suggested a new online service, CircleLending. The Cambridge, Mass.,-based firm helps borrowers and lenders draw up contracts and repayment schedules.

"It was good to have a neutral arbiter who will suggest something that works for everyone," Mr. Martin says. It was by no means a sweetheart deal — a 10-month loan at 15% — but the restaurant opened in time for tourist season.

Seed-money loans from friends and family are as much a part of entrepreneurial legend as garage workshops. Bill Gates and Steve Jobs got their initial funding that way. Atlantic Records founder Ahmet Ertegun borrowed his startup money from the family dentist. As accurately as anyone can measure, there are US$65-billion in friends and family loans outstanding.

Not every business funded this way will grow into a Microsoft or an Atlantic. History suggests about 14% of such loans are never paid back. In that high-default rate, Asheesh Advani saw an opportunity.

A former World Bank consultant who worked on micro-loan programs in developing countries, Mr. Advani figured the informal, handshake nature of these loans was part of the problem. So three years ago he set up CircleLending to be a middleman in these transactions. By using standard loan documents and elementary technology — e-mail and electronic transfers, for example — CircleLending makes it simple to structure a loan and pay it back. The company charges set-up fees of US$49 to US$1,500, plus 1% to 2% of the payment.

DEFAULT RATES FALL 9% JUST BY HAVING LOAN AGREEMENTS

Mr. Advani found that simply drawing up loan agreements can bring defaults down to 5%, much closer to the 3% default rate for credit cards. "When you use automatic payments from a bank account, the default rate drops even further," he says. For their part, lenders and borrowers have found that going through CircleLending can prevent some awkward conversations at family gatherings. So far the site has processed about US$3-million in loans.

While using an intermediary is not necessary, it is essential to formalize an arrangement. "Any loan for any amount should be documented in some way," warns Kevin Meuse, an estate planning lawyer with Boston's Kirkpatrick & Lockhart. For most of these deals, legal software such as Nolo's Quicken Lawyer can provide all the fill-in-the-blank forms needed. It is also a good idea to check with an accountant or financial planner.

An advantage to a service such as CircleLending is it reminds the debtor of the obligation. Tom Binning gave Eric Bobby, a friend and former colleague, a $5,000 loan to jump-start CityKi, a company that installs Internet kiosks in inner-city stores in Atlanta. Mr. Bobby had trouble making his payment one month. "I let CircleLending know, and they e-mailed Tom to ask if I could defer that payment," he says. "He OK'd it."

CircleLending does not operate in Canada, but its Web site, www.circlelending.com, has some interesting tips in its FAQ section.