Transition – One More Challenge for Small Business

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SMALL COMPANIES CAN TRANSITION QUICKLY

Start-ups first of all, have to survive. If they can do that, they then face a number of critical "transition points" as they continue to grow.

Friends and family financing or crowd sourcing can only take you so far. Debt, alliances or joint ventures may be the next step. Eventually, a track record is established. That's critical. Fast moving small companies can outgrow their bankers quickly.

A private capital deal may be the next order of business. But even angel investors don't want to stay on board permanently. Planning an IPO is likely the next logical step.

Start-ups can find themselves considering public offerings within 10 years of launching – some much faster than that!

That's a good thing.

Canada needs businesses that transition

The next 20 years will be incredible. Green energy, the "internet of things", big data and millennials – developments we know for sure are making their mark are huge opportunities for Canada. They are just the beginning. Leading edge, is no longer the safe haven for North American and European companies that it used to be. This is a "world wide" world and there is no shortage of good ideas and smart people to make them happen.

The reality for Canada is that natural resources may become a less reliable contributor to GDP. The innovative start-ups of today will be critical to our ability to generate the jobs that will be needed and to sustain our standards of living.

Companies may become even more virtual in that they may become less centralized, functioning in an on-line environment. But it is still going to be companies, and not just individuals that will be the locus of capital generation. They will remain the best form of organization in which to house talented teams.

The key to their success will be their ability to transition quickly to access the financing they will need. They will be competing with the rest of the world and they will need to be able to transform quickly to keep up and to keep investors interested.

It makes sense that companies should start, grow, seek financing and perhaps eventually additional investors – somewhat in that order.

That is not always the case. Silicon Valley is famous for launching start-ups fuelled with significant levels of private capital. Some start-ups go public immediately.

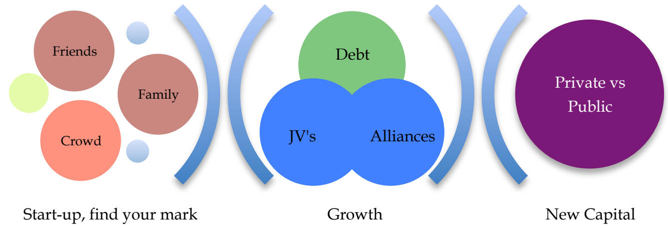
There are a number of privately owned companies that remain closely held that are highly successful and plan to grow modestly.

If Canada can't foster the creation of companies large enough to engage competitors in new arenas throughout the world, our standard of living will diminish.

It is from today's start-ups that our large companies of tomorrow will emerge.

From Canada's perspective, it is important to consider that economic diversification will become more critical. Expanding trade links for existing products will only do part of the job. New products and services, the stuff of an "ideas" economy are needed to do the rest.

TRANSITIONING IS LIKE EVOLUTION – JUST QUICKER AND WITH MORE FINANCING INVOLVED



The major transition points for most fast growing companies are defined by the way they finance growth.

Start-up

Start-ups require friendly capital. LEAN start-ups are apt to pivot and sometimes change direction completely. Friends and family can help. So can crowd sourcing. If you want to get invited to family outings and have any friends left, formal agreements and clear understandings are vital.

Growth

Once a venture has found its path, and its market, getting viable and sustainable means sales have to be generated, products enhanced and service levels improved. Partnering and venturing can help. More likely, some debt financing will be needed. Alternative financing vehicles may need to be considered before approaching a mainstream lender. Eventually, junior capital such as mezzanine or subordinated debt may be accessed. Accessing money from organizations in the business of supplying it means meeting commitments. Outsiders are now looking in on how the business is doing and that means accounting and control systems as well as leadership and governance have to be brought up to par.

New Capital

The more quickly a business grows, the more likely it is that bankers will be outgrown. Alternative financing will become too expensive. Mainstream lenders will start to bristle at the debt to equity ratio. New investors will be required and they will want some level of control. Negotiating the level of control or ownership that will be relinquished to achieve various levels of financing will involve intense negotiation. If reasonable terms can be negotiated, and the new investors bring additional expertise, the benefits can be significant. Private capital will however always look for an exit strategy, and increasingly that is likely to trigger an initial public offering.

Adapting to Transition

It is almost impossible to overstate the importance of ensuring the organization develops quickly and capably enough to meet the expectations of lenders and investors. Those that don't develop will find the cost of financing to be more expensive, and the terms more onerous.

As companies grow expectations regarding their sustainability increases. Yes, a great product can continue to attract investor interest, but it is not the product that will receive the investment – it's the company. If an investor is not confident the business can be run effectively, be well controlled and well led, then perceived investment risk is thought to be higher. That means higher interest rates on loans if the company borrows. If equity investment is sought, and investors are not confident the company's management will deliver, they will want a greater number of board seats and likely a say in the selection of the CEO.

The following table summarizes key comparative criteria for fast growing organizations to consider. As the company transitions, its management is expected to become more sophisticated. Strategies are expected to be more long lasting and the degree of success more carefully articulated. Risk management will play a greater role in decision making and it will become more important that projected risk adjusted rates of return have a high probability of being achieved. Lenders and investors expect the quality of information and reporting to align with the complexity of the business. External reporting such as financial results and compliance becomes increasingly more onerous. It is expected management is basing their decisions on good information. It is also expected that governance will mature as the company continues to grow.

All this takes time and costs money. The timing of investments in leadership, planning, information systems and controls can't be made too early or momentum will suffer. Left too late, the business may become less controllable. Making the right decisions at the right time can spell the difference between success and failure.

	Start-up	**Growth**	**Private Capital**	**Public Capital**
Management, Organization, Succession and Governance				
Strategy Setting, Operational Planning and Execution				
Risk Adjusted Rate of Return, and Risk Management				
Financial Reporting, Internal Control and Quality of Disclosure				
Oversight, Early Warning Indicators, Crisis Planning				

*** Source – Abridged from Upturn Consulting's Planning for Transition**

OPTIMIZING PERFORMANCE THROUGH TRANSITION

Performance against peers is as important for start-ups as it is for companies that have hit their stride – even more so when they have to compete for investment capital. Performance must therefore be assessed, not only against stated outcomes, but against performance of the sector.

Expectations and the rigour with which performance is measured will increase as companies grow. Start-ups are not expected to have the same expertise as capital seekers. Then again, in each sector, the 80/20 rule will apply. For any sector, there is only room for one or two top competitors. Therefore, no matter what stage the company is in terms of its development, it must seek to excel if it is looking to grow further.

Are we worth more today

A company's value must grow in real terms or it will fail. The company has to set specific performance objectives. If innovation, execution and vision come together, value increases

Do we compete well now

Ideas, assets, the way they are financed and managed can provide sustainable benefit when matched with the right strategy.

Are our leaders right for us

Companies require vision to draw them forward. Leadership and execution make the vision real. .The skills needed to lead companies from start-up to IPO are different. New leaders may be needed from time to time.

Are earnings the right quality

The quality of earnings drives sustainability. Companies can benefit from periodic lifts in earnings - say from a bubble environment, but if the underlying earning power is not up to par, watch out!

Are we bankable

A company knows it is doing well when bankers and investors are easily accessed and show quick interest. Liquidity and capital are the lifeblood that enables transition.

*Source – Adapted from Upturn Consulting's Planning for Transition

Risk-Adjusted Rates of Return and Stress Testing

Companies operating in different sectors deal with different types of risk. Start-ups, companies financing growth with debt, and those seeking private or public capital have differing risk profiles. The complexities grow when timing is taken into account, and investment alternatives are considered.

Sometimes it may not be sufficient just to be the leading performer in a sector. If the sector is in trouble, even the best performers may suffer by virtue of changing risk appetites on the part of bankers and investors.

If a company has a good product and can show that it has the capacity to deliver there will always be investors prepared to listen. The key is to generate financing at the best cost. When seeking capital a company has to determine if the initiatives it plans to undertake will provide a sufficient return to compensate investors for the risk they are being asked to finance.

Once the risk-adjusted rate of return has been determined two additional steps need to be taken. The first is to set out a risk reduction program. As companies achieve critical milestones, risk to investors will be reduced. That is as true for start-ups as it is for more established companies. As examples, companies reduce risk when they meet objectives such as recruiting a key executive or successfully installing new production capacity. When steps are completed that were essential to a company's operating plan, risk is reduced.

Next, it is necessary to demonstrate that the company can remain viable under the most trying conditions. That's where stress testing will prove useful. Effective stress testing rests on the ability to define what really drives the business, and testing what happens when those conditions change. As an example, a start-up software developer is affected by customer spending power and demand, competitor offerings, the ability to recruit and retain sales and development staff and changing technology platforms. Showing that the company knows how it will deal with changes in some or all of these business drivers is essential when seeking loans from bankers or new investors.

Rates of Return, Drive Performance which Drives Financing – That's What Drives Transition

A start-up company that has reached its market and can now show it has the capacity to deliver a good product reliably with positive cash flow is at a transition point. It can now seek financing to accelerate growth. Achieving steady performance is critical. It is one thing to get the product moving, but at the same time, the company has to show that it too is developing. If not, it is nearly impossible to convince lenders and investors that momentum can be maintained. It is the development of the company itself that allows a start-up to transition to high growth.

The same holds true when high growth companies begin to outgrow their bankers and have to seek external capital. Investors want assurance that the company is not only going to be able to maintain current revenue growth, but be able to cope when growth rates accelerate.

As companies transition, the stakes increases and it is their level of development as functional entities that will provide the basis on which to move forward.

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Helping companies in transition

Companies that transition from start-up, to high growth may then need to seek external capital and perhaps eventually an IPO.

At each transition point, strategies and risks must be assessed, financing sources identified, and change management programs re-geared.

That is where Upturn Consulting comes in.

Whether it is deciding a strategic path, assessing risk and return opportunities or making key people decisions, Upturn can help.

Upturn works with clients to identify financing options, helps to develop term sheets and advises on negotiating strategies when new financing is sought.

Upturn works with clients to identify the changes they will need to make to continue to grow and where to focus their efforts.

The key is to ensure probabilities of success are evaluated in measureable terms. Then specific steps are identified to ensure those probabilities are enhanced.

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Areas of consultancy include corporate governance, risk management, strategic assessment and business reorganizations – including mergers and acquisitions.

Prior to accepting an engagement, Upturn determines client requirements and makes a determination of the outcomes that must be delivered to add value to its clients. Client requirements and value added outcomes form the basis of the agreements that are reached before engagement letters are signed.

Upturn provides on-site management for client projects if required.