ENERGY
CATALYST

Investment guide: Equity

Introduction

Equity financing is a form of investment where capital is deployed into a business in exchange for shares in the business. Equity investors become partial owners of the business, sharing in its profits and losses. This type of financing is commonly used by early-stage businesses (pre-revenue and pre-profit), which have minimal cashflows and need capital for growth and expansion.

This guide explores the dynamics of equity financing, highlighting the roles and characteristics of different equity investor types. It also delves into the benefits and risks of equity financing, to help entrepreneurs understand this form of capital.

Key terms in equity financing

Key terms		
Term	Description	Business consideration
Equity	Ownership in a company, typically in the form of shares or stock. It represents the residual interest in the assets of the business after deducting liabilities. Equity investors are entitled to a portion of the company's profits.	Businesses should carefully evaluate the percentage of equity they are willing to offer in exchange for capital. Dilution of ownership and decision-making control are important considerations to weigh against the financial benefits of equity investment.
Equity investor	Individual or entity that invests capital in a business in exchange for equity ownership. This can include angel investors, venture capital firms, private equity firms, institutional investors, and even crowdfunding platforms.	Businesses need to assess the specific expertise, networks, and resources that equity providers bring to the table. Aligning the goals, values, and long-term vision between the business and the equity provider is crucial for a successful partnership.
Valuation	The process of determining the worth or fair market value of a business. It involves assessing several factors such as financial performance, assets, growth prospects, market conditions, and comparable transactions.	Companies seeking equity financing must understand their valuation and be prepared to justify it to potential investors. A realistic valuation is necessary to attract investment and increase the chance of a successful equity fundraising.
Dilution	Occurs when additional equity is issued, resulting in a reduction of existing shareholders' ownership percentage in the company. Dilution happens when new equity investors come on board or when equity-based employee compensation plans are implemented.	Existing shareholders need to carefully consider dilution to ensure their interests are protected. Dilution can affect control, voting rights, and future financing options. It is important to strike a balance between raising capital and preserving ownership.
Investor rights	Privileges and protections afforded to equity investors. These rights can include information rights (access to financial and operational information), approval rights (such as major business decisions), and rights to participate in future financing rounds.	Entrepreneurs should carefully evaluate the investor rights requested and their potential impact on decision-making and operational autonomy. Balancing investor rights with the entrepreneur's vision and operational flexibility is crucial for long-term success.

Key terms		
Board representation	Refers to the right of an investor to have a seat on the company's board of directors. It allows investors to participate in strategic decision-making processes within the business.	Entrepreneurs should assess the balance of power, expertise, and alignment of interests between the investor-appointed board member and the entrepreneur.

Types and sources of equity financing

There are various types of equity investment for founders to choose from depending on their business stage and long-term objectives as set out in **Error! Reference source not found.**. Each investment instrument carries a different risk and reward profile, which in turn impacts which investor type will be most appropriate at each business stage as demonstrated in Figure 2.

Figure 1: Types of equity

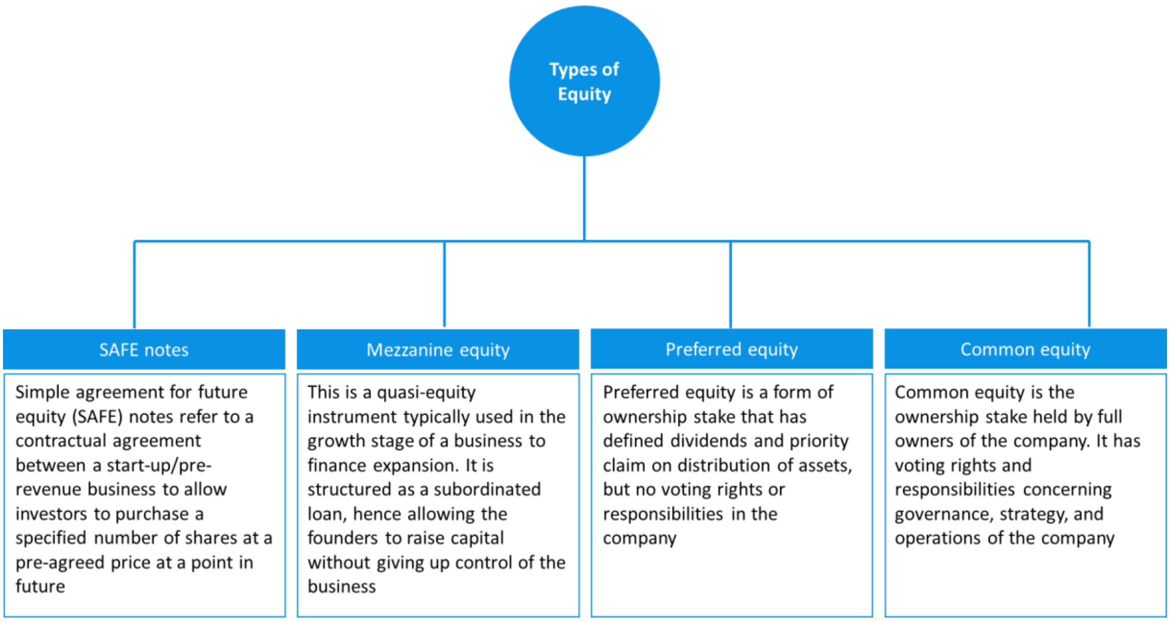
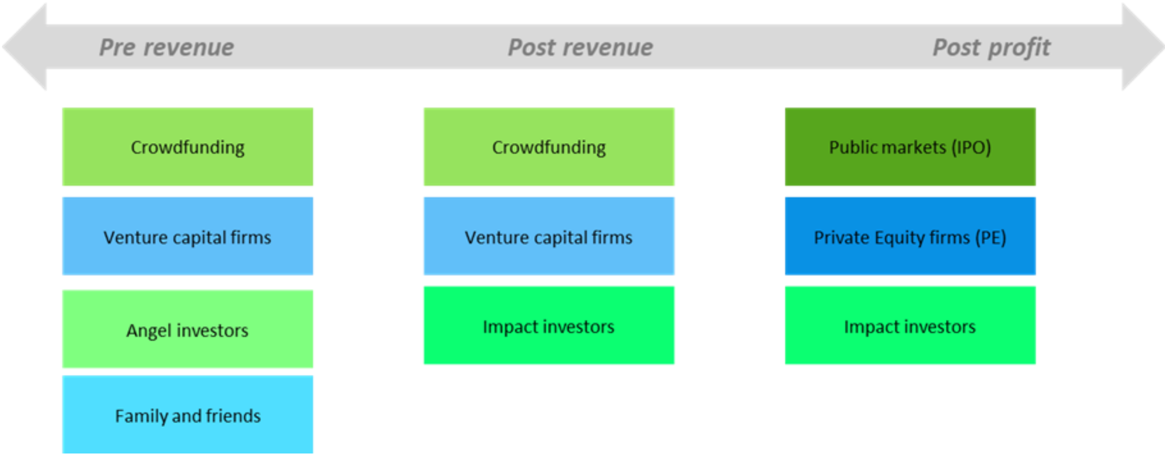


Figure 2: Sources of equity



Source of Equity	Description
	Pre-revenue
Family and friends	Family and friends are usually the first source of external finance for a business. They have flexible repayment periods and low interest which is useful to pre-product and pre-revenue businesses.
Equity-based crowdfunding	Equity crowdfunding is raising equity by offering shares or ownership stakes to many individual investors through online platforms. This method can help startups access funding from a broad investor base and gain initial traction.
Angel investors	These are typically high-net-worth individuals who invest in pre-revenue businesses through equity or quasi-equity instruments. They may be mission-driven industry experts, looking to share knowledge, expertise, and networks through closer mentorship of entrepreneurs, or simply motivated by the opportunity of outsized returns associated with investment in higher-risk earlier stage businesses.
Venture capital firms	Venture capital firms invest in high-potential pre-revenue companies in exchange for an equity stake. Venture capital investors provide essential seed capital and signal confidence in the market potential, technology, or business model of the start-up. This allows businesses to develop their products, build their teams, and lay a foundation for future growth, while also attracting additional investors, customers, or partners who may be more reluctant to work with an early-stage company.
	Post-revenue
Equity-based crowdfunding	Equity crowdfunding at the post-revenue stage involves offering ownership shares to a diverse group of individual investors through online platforms. This approach enables established startups to secure capital from a wide range of backers and further accelerate their growth and expansion, leveraging their existing revenue streams.
Venture capital firms	At the post-revenue stage, venture capital fuels scaling efforts by offering significant capital for rapid

Source of Equity	Description
	expansion and leveraging extensive networks to form strategic partnerships that drive growth and create synergies. This enables post-revenue businesses to accelerate their growth trajectory, achieve significant market share, gain access to new markets, secure valuable distribution agreements, and enhance their competitive position in the market.
Impact investors	Calls for cooperation and cross-sector collaboration to solve global challenges such as poverty, climate change, and hunger, have led to the emergence of impact investors. These are investors who focus on initiatives that have an impact-first criteria before financial return. Examples of impact investors include Development Finance Institutions (DFIs), private foundations, and impact funds. Impact investing is explained further in the special instruments guide.
	Profitable
Private equity firms	Private equity funding at the profitable stage of business may take two forms: growth financing or buyouts. Private equity firms channel investments into highly profitable, mature businesses that need additional capital to fund growth of products or markets in exchange for equity stake in the company. In the buyout scenario, private equity investment is used to purchase the entire stake of an existing mature business.
Public markets (initial public offer)	Mature, profitable companies can raise capital for growth from public markets by offering their shares in a new stock issuance. IPOs are also used as an exit option for private investors since they provide a premium on shares, thus allowing them to realize the gains from their early investment.
Impact investors	Calls for cooperation and cross-sector collaboration to solve global challenges such as poverty, climate change, and hunger, have led to the emergence of impact investors. These are investors who prioritise initiatives that have an impact-first criteria before financial return, even as they aim for profitable returns. Examples of impact investors include Development Finance Institutions (DFIs), private foundations, and impact funds. Impact investing is explained further in the special instruments guide.

An investor could sometimes invest in businesses at distinct stages of maturity taking a portfolio approach to de-risk investments. However, the table above gives an indication of the typical investors a company can approach based on its stage of maturity.

Other early-stage investment support

Companies seeking early-stage capital may also find non-financial resources available at business incubators, accelerators, and as set out below.

Type of support	Support offered
Business incubators	Development of pre-revenue businesses or concepts through the provision of wide-ranging support such as business coaching, access to business networks, etc, provided in return for equity.

Business accelerators	Development of early-stage businesses through wide-ranging support including investment readiness to speed up the path to profitability and external fundraising rounds, provided in return for equity.

Company valuation methods

Company valuation is a key component of the equity financing process that involves assessing the total economic value of the business. The value established lays the foundation for term sheet negotiations.

The methods used in company valuation vary depending on the life cycle stage of the business as each stage presents unique characteristics and challenges.

1. **Early-stage businesses** – During this stage, the business may not have operating history or be generating revenue. As a result, investors focus on the market opportunity that the firm can capture and revenue potential to determine its value. Some of the methods used include:
    a. ***Discounted cash flow (DCF) -*** This method estimates the present value of the company's expected future cash flows, adjusting for factors such as revenue growth, profitability, and risk.
    b. ***Comparable company approach –*** This approach estimates a company's value by comparing it to similar companies in the industry that have raised equity. It considers factors such as revenue, user base, and market potential as reference points for determining comparable value.
    c. ***Venture capital method -*** This method involves estimating the company's value based on the expected return on investment and the level of risk associated with the investment.
2. **Growth-stage businesses** – During this stage, the business has developed a functional product with proof of concept and is generating revenue. The valuation methods used are therefore a mix of quantitative and qualitative concepts to capture the company's growth potential.

Quantitative concepts include:

a. **Multiples approach (precedent transaction analysis) –** This method uses multiples based on financial metrics as a yardstick to assign value. Some of the commonly used multiples include price/earnings (P/E) ratio, enterprise value/ EBITDA, and dividend yield. These metrics are compared against similar companies whose valuations are public to establish comparable values.

Qualitative concepts include:

a. **Premiums –** Premiums assign additional values to a company's shares based on qualitative factors such as leadership quality, brand reputation, growth prospects, competitive advantages, unique technology, or significant market share. This approach helps stakeholders and investors recognize and account for a company's competitive strengths, leading to a higher valuation than solely derived from financial metrics.

b. **Discounts –** Valuation discounts are applied to companies in volatile industries or facing regulatory uncertainties. Appraisers evaluate potential risks and weaknesses, considering factors like market exposure, reliance on a single customer, regulatory challenges, financial stability, and management risks. Applying discounts during growth stages ensures potential investors and stakeholders consider the risks and limitations of the business, resulting in a lower valuation than derived solely from positive financial metrics.

Benefits of equity financing

Key	Benefit	Description
	***Access to capital***	Equity provides an opportunity for businesses to raise funds for growth initiatives, expand operations, develop new products, or enter new markets.
	***Long term funding***	Unlike debt financing, equity financing does not have a fixed repayment schedule. Investors become shareholders and provide funding with the expectation of sharing in the company's future success. This long-term nature of equity financing provides businesses with stability and flexibility in managing their financial obligations.
	***Shared risk***	With equity financing, the burden of risk is shared between the investors and the business owners. Investors are willing to take on the risk associated with the company's performance because they have a stake in its success. This shared risk can provide a sense of security for business owners and reduce the pressure of repaying debts during challenging periods.
	***Expertise and guidance***	Equity investors often bring more than just capital to the table. They can offer valuable expertise, industry knowledge, strategic guidance, and mentorship based on their experience. This can help businesses make informed decisions, refine their strategies, and overcome challenges.
	***Network expansion***	Partnering with equity investors can expand a business's network and access to resources. Investors may have a vast network of contacts, including industry professionals, potential customers, suppliers, and other investors. Leveraging these networks can open new opportunities for collaboration, partnerships, and growth.

Key	Benefit	Description
	***Enhanced credibility***	Securing equity financing from reputable investors can enhance a business's credibility and reputation. It serves as a vote of confidence in the company's potential and can attract further interest from customers, suppliers, and other stakeholders. This increased credibility can help in attracting top talent, negotiating favourable partnerships, and differentiating the business from competitors.

Challenges and risks of equity financing

Key	Challenge/ risk	Description
	***Loss of control and decision-making power***	Equity financing can lead to a loss of control and decision-making power for the original founders and shareholders as new investors with different perspectives and strategies come on board.
	***Dilution of ownership***	Issuing new shares of stock as part of equity financing can dilute the ownership stake of existing shareholders, reducing their proportional ownership.
	***Investor expectations and demands***	Equity investors often have specific expectations and demands regarding the company's growth and profitability, which can create pressure on the management team to meet aggressive targets and shift focus away from long-term sustainability.
	***Impact on company culture***	Introducing external investors through equity financing can impact the existing company culture, potentially creating tension and challenges in maintaining a cohesive and aligned culture due to differing risk appetites, management styles, or strategic priorities.
	***Market volatility and investor sentiment***	Equity financing carries inherent risks related to market volatility and investor sentiment, as the value of a company's shares can fluctuate significantly based on a range of factors, potentially affecting the overall valuation and future funding prospects of the company.

Further reading

Equity Financing - https://www.investopedia.com/terms/e/equityfinancing.asp

Equity valuation - https://corporatefinanceinstitute.com/resources/valuation/equity-valuation/

Equity valuation methods - How to Value a Company: 6 Methods and Examples | HBS Online

Types of Equity financing - https://www.thebalancemoney.com/types-of-equity-financing-for-small-business-393181

The Equity financing process – https://fastercapital.com/content/The-Equity-Financing-Process-a-Startup-Investor-s-Guide.html