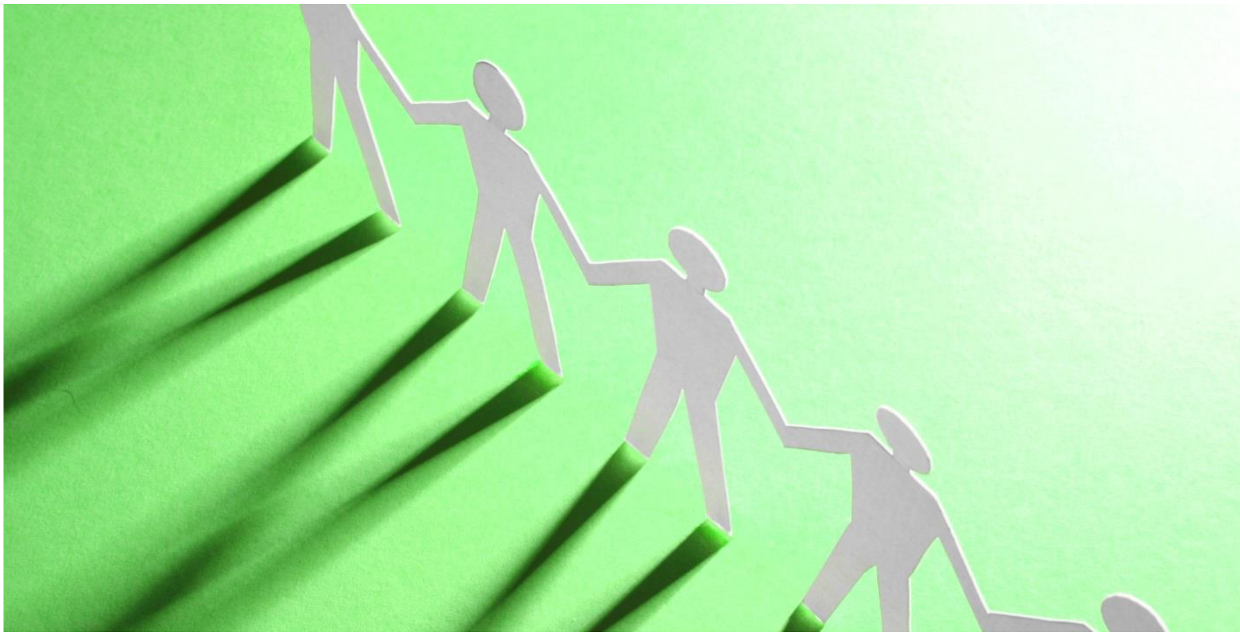
Entrepreneurs—Wary of Dilution?
A Perspective to Consider



Most entrepreneurs are loath to give up equity—anyone who has ever watched Shark Tank knows that. And it makes sense. After all, it's *your* breakthrough idea, *your* money (and sometimes your family's and friends' money), *your* sleepless nights and *your* hard work. When you're pouring all that into a venture, you should be the one to call the shots and reap the spoils. It stands to reason that the more equity you take—in other words, the more ownership you give away—the less control you have over your business. And of course, you stand to make less money upon exiting, right?

In my experience this thinking may be shortsighted.

Giving up equity may go against your beliefs, but the right investment partner can help you substantially grow your business, which rarely has everything it needs from the outset. More than just cutting you a check, an investment partner can provide strategic guidance, help you round out your management team, and often introduce you to powerful networks of potential customers and co-investors, all of which can make your company far more valuable than you would likely achieve on your own. (As for dilution, let me ask you: Which would you rather have, 50 percent of $5 million or 5 percent of $100 million?)

Harvard Business School professor Noam Wasserman, in a forthcoming paper to be published in *Strategic Management Journal* called "The Throne vs. the Kingdom: Founder Control and Value Creation in Startups," writes that, "Startups in which the founder is still in control of the board of directors and/or the CEO position are significantly less valuable than those in which the founder has given up a degree of control." Wasserman, whose study looked at 6,130 U.S. companies, writes, "On average, each additional degree of founder control (i.e., controlling the board and/or the CEO position) reduces the value of the startup by 23.0 percent to 58.1 percent."

If you've shied away from dilution in the past, here are three key reasons to consider it:

1. **You'll receive critical funding.** Obviously, you need cash to produce prototypes, manufacture and market products, hire key employees and otherwise build your business. And, this takes substantial sums of money—always more than anticipated—because the only thing that is assured when a business plan is written is that things won't go exactly that way. You need to raise enough to achieve meaningful milestones and be able to raise additional capital down the road. Don't be afraid to ask for enough money. It's far better to extend your timeframe so you're not spending all your time fundraising. And, you improve your leverage when you raise more than you think you need, so that you don't have to take the next dollar from the wrong investor or before you're ready. Be careful to keep your focus on the long-term goal

of value creation, rather than just how much money (and dilution) you need for the next short-term milestone—it takes substantial cash to build a business from the ground up—plan on it.

2. **You'll receive strategic assistance.** Don't undervalue this benefit. Most entrepreneurs want to call the shots at their companies—and most do, even after giving up equity. The typical board of directors only meets every other month; the rest of the time the CEO who is running the company and it is he or she who is responsible for creating value. It's a common misconception that your board will tell you what to do. Rather, your board is there to represent all shareholders, challenge your assumptions, debate and approve your strategy, and help you course-correct, as necessary. And, your board should not just be management and investors. Independent industry veterans who have previously gone thru the process of growing a business should round out your board and be available to coach and advise. Your investors and the entire board are a critical part of your team that should have the strategic know-how to help drive your success.

3. **You'll make beneficial connections.** If there's one thing I wish I could impart to every CEO I work with, it's this: Know your strengths. If you've made it to the place where VCs are interested in you, you definitely possess certain critical skills, but you can't possibly have them all. The right investment partner will help you round out your core management team, whether you're light on finance, operations, marketing, sales, or another critical function. And, investment by credible VC's will provide you with validation and visibility. VC's also have connections to potential customers and co-investors—valuable networks that can help you vastly strengthen both your position in the marketplace and your balance sheet.

Choosing an Investor

Convinced that dilution is a smart decision? If so, and you decide to seek an investment partner, choose wisely. Look for a partner who has domain expertise and plays in your space so that you can lean on its team for strategic support. It's also critical to choose a partner who shares your vision and timeline, since you'll be making important decisions together. The right partner or partners must also have valuable contacts you can leverage, and of course enough money to invest additional capital when you need it.

Working with an Investor

You and your investment partners should work together to understand industry standards and set realistic milestones. It's important that you don't go too far afield or have unrealistic expectations. Your investor will be happy if you meet your milestones and create value. We also encourage entrepreneurs to begin building a strong set of advisors (in addition to an experienced board of directors)—and to consult them regularly, involving them early and often. One thing founders typically don't do is communicate bad news early. When you do, though, you and your advisors can work together to fix problems before they become insurmountable.

Bottom Line

If you are at the helm of a startup and you're trying as hard as possible to retain ownership, you could be holding your company back. Successful companies typically have growth capital dilution. In fact, successful companies *expect* dilution. Try focusing on growth and the necessary capital to hire the best talent, attract reputable, referenceable customers, and aggressively expand your product offering, rather than worrying about dilution.

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