IS GIVING AWAY EQUITY IN YOUR BUSINESS A SMART IDEA?

Is giving away your equity in your business a smart idea? Podcast Transcript

Good morning, this is Rhys Jones. Welcome to my podcast. Today I want to talk about is it a smart idea to give away equity in your start-up.

The question is probably twofold. Is it equity you're going to give to a business partner or new employee for your start-up or is it an investor that isn't going to work in your business alongside you; it's either a cash investor or a cash investor that's also going to be a working shareholder. So, we'll look at the working shareholder situation.

Do you or don't you

If you are looking or been offered an investment into your start-up, which is more of a cash investment, and this is from maybe a family or friend or somebody new from your network of friends who isn't necessarily in the recruitment industry but is a businessperson and wants to help you. I would say don't. The reason being is if you're giving away a percentage of your business just for cash, you've got to bear in mind where you'll be in three to five years' time. It also depends to a degree on the size of business you're looking to grow and so there isn't a catch-all answer to this. If I'm asked this question, I do go through a lot of questions on a coaching situation to help somebody come to conclusion. But if it is just that you want start-up capital, it can be really expensive paying that back over the lifetime of your business in profit share if somebody doesn't add value to the business.

Consider what they will add

I think the question you really need to ask yourself is will that investor add value to your business. That is more important than cash. It's easy to talk about cash if it's not important if you've got cash. There are ways of getting money, there's ways of starting up without an awful lot of cash but really if you're looking for a start-up investor, what value will they add, and my experience tells me if they're not from the recruitment industry they're not really going to add any value.

I've heard examples of 'well they've got an office; they can offer me a desk and they'll help with the setup'. Well okay having a desk and people around you, that's nice, but the set-up of a recruitment company isn't actually that complicated. To then get a payback for the rest of the life of the business, that's a lot and it's a sort of thing that further down the line is probably going to burn and grow. I've come across a number of people, not just in recruitment, outside recruitment, who have had business partnerships with shareholders that they've started to really resent the situation further down the line.

That then stifles the growth of the business because you're not looking to grow the business because you're too busy thinking about the money that this other person's getting. If it's just a cash investor, I would avoid it at all costs.

A billing investor

The other type of investor is somebody who maybe works in the recruitment industry that is going to add genuine value to your business. That's an equation worth thinking about. However, what I would say is how much time would they put into your business. So, if this person currently owns a recruiting business and they're looking to maybe offer you a desk and say ‘we'll put a bit of money in, and you could work in the office, and we'll help you with the business’. They're probably not actually going to spend much time on your business because their business will be significantly bigger.

How much help are they actually going to give you? Now this is a broad brush; it depends on the person. There's going to be some people out there that are really going to help you a lot but through my experience they really are in the minority. It's just a romantic idea to see the sort of thing that Davidson Gray do, and they think ‘okay well that's easy, what I'll do is I'll just off this guy a desk, give him some initial money to cover his first few months’ salary, then I get 25 or 50% of the company. And then they don't really give any value. And again, that sort of thing can grow into more of a caustic relationship.

So again, it's all about diving deep into what the value is. It also depends what equity you're giving away, because I've mentioned this before in previous blogs and I've done a podcast, with equity, if you're giving away let's say 25%, it doesn't necessarily mean you’re giving away 25% of profit and it doesn't necessarily mean you're giving away 25% of sale. It's whatever you decide it to be in the shareholders agreement. Also when it comes to profit, there are other things that can complicate it and what I mean by that is, say for example if you're offered equity in the existing recruitment business that you're working in at the moment, the profit you get can be diluted by taking out very big pension contributions by the owners because pension comes out of profit, so it's a diluted profit.

Think about the detail

There's also to bear in mind what sort of profit it’s actually going to give you because if they have notional basic salaries, again that reduces the profit. So, if you're looking at your start-up, if you are looking at percentage of profit - let's say somebody put some money in and say ‘I'm going to take 25% of profit off’ - it's usually a lot more than actually 50% to be fair. We take 25% but I think we're unusual in that respect. So, if you take 50%, is there going to be a notional basic and what I mean with notional basic is because when you pay yourself your drawings out of your start-up or your SME, you will pay yourself in dividends.

So, when you get into the basic salary, by definition you're probably talking about a PAYE basic which is where you're not taxed at a dividend rate, which is a preferable rate, but in your own business, your SME or start-up, you have what's known as a notional amount. So, for example, if your notional amount is a hundred thousand, that hundred thousand comes out first and goes to you and then the profits are divided. So, it can be a different set-up, so the devil is really in the detail. I think it's worth mentioning now, the other alternatives you've got which is to a degree a self-promotion situation - I can't get around that - but I can't present you with a different option otherwise. The way that we work is I take 25% of ownership within the companies I set up, but I do all the funding initially, so obviously there's cash coming in.

A different approach

But from there on the support that I and my colleagues at Davidson Gray offer is we do all the accounts, we do the marketing, we do all the support that you could possibly need that would leave you such that really all you need to do is bill and manage your team. So, I'm a working director. That's very different; it's like having a business partner in a new start-up that's a biller. So, say you have a colleague you want to work with, and they bill £200k a year and you want to give them a percentage. I work in a similar kind of way, but more at a directorial level. So, I look after the operational side and the marketing side and the long-term vision of growth. Clearly that's in coordination with the MD. I don't run the businesses like they're my businesses. I put as much passion in as if they were my businesses, without a shadow of a doubt, but I've built my businesses and for me to build them just again using the blueprint - that doesn't give the job satisfaction.

The job satisfaction I get is helping people grow their businesses their way but avoiding the bumps in the road and making a lot of money quicker, faster, and safer with less stress with the help that I can give. So that's a different proposition. And not wishing to overcomplicate it but for the first few years of the business, I don't actually take profit, I just take a percentage of revenue. The reason for that is it keeps the relationship simple so the MD of the business can spend as much as they want on whatever they want, whether it's expensive offices or cheap offices, big salaries, small salaries, because if I take a percentage of profit, that can only lead to disagreements on certain things and I don't fall out with any of my business partners.

I want to do this just for fun. I don't need to work anymore so I set up an arrangement such that there's never any real disagreements so we can just have fun making money, which is the important thing. That's probably another thing to bear in mind - if you have a cash investor, when it comes to profit, they may want to take more ownership of what you spend, what you don't spend, so it could feel like you're working for somebody else and it also could lead to fall out. So, the relationship I have with the Davidson Gray partners is very much a working situation where I will do as much as they would like me to do in growing the business on the operational side. Obviously, the coaching and mentoring and setting the business up to allow them to make a lot more money because they're not spending time doing the other stuff that's going to take away that time.

So as a commercial trade-off, if you're looking at the 25% that we take, that 75 percent that's left over will be worth about two, three, four times as much as 100% would be because you've got somebody experienced on board that is not only helping and mentoring and coaching through experience, but actually doing a lot of the heavy lifting. So that's slightly different but that is another option. I'm not necessarily the only person that does this, however I think I'm the only person that's a working director. Most of the other people that do this kind of arrangement will offer a mentoring and coaching as well as some back-office support, but they won't necessarily work on the business with you. That's a bit unfair because I don't know everybody in the country that does this; there may be somebody like me out there. I can't say I'm unique.

Going back to the situation of equity with employees, I did cover this in another podcast on how to hire your first employee to your start-up and to get to the first two or three staff is very difficult. Nobody really wants to join a one-man band, so sometimes it can be in your interest if you've got a known entity, a good biller, that you know you can work with that can probably add a bit more value to the business longer term. Give them some equity now; it may be an excellent opportunity for them because they'll earn a lot of money further down the line but also it helps you fast track to get to that critical mass because you can get stuck within the first year or two with no staff. It's difficult to get those staff so if you get in two, three, four staff, some of them maybe have an amount of equity, which can fast-track you to three, four or five staff.

Conclusion

It's then a hell of a lot easier to attract staff to the business because it's a going entity, people are interested in joining it. So, to get to that level, if it means giving a bit of something away now, that can actually be a smart idea. Especially if it's somebody that is going to add value to the business. That could be a really smart idea. But you need to think carefully about it and also the devil is in the shareholders agreement. If you give them 20%, do they get 20% profit. Is that profit after their basic salary. Is it just on the sale of the business. You know, there's various ways to give equity to somebody and it depends on your long-term plan or whether you're looking to sell the business. That's something to bear in mind, but if you want to listen to my other podcasts on how to make your first hire there's more elaboration in that one. This one is probably more so to look at the investment point of view; to bear that in mind as to whether it's just a cash investor, someone that's got experience or whether it's actually a working investor. That's really where you want to look at - is there going to be long-term value and that can help you make your decision.

I hope you've enjoyed this podcast; if you are interested in setting up your own recruitment business, feel free to contact me on LinkedIn and we can arrange a chat.