1

Marketing to Investors and Lenders: What the Capital Markets Want

Until recently, entrepreneurs or corporate managers who needed to raise capital had limited options. Money from investors and banks did not flow freely to the businesses that could most profitably invest it because there were always regulatory, institutional, cultural, or technological barriers that restricted capital flows. Now all of this has changed. It is easier to get funding from international sources because the foreign exchange controls that limited flows from one currency to another largely disappeared a generation ago. It is easier to sell stock in your company because stock exchanges have made it easy for investors to get into and out of financial markets. Plus, attitudes to investing have undergone profound changes as a whole new generation of investors, in the United States and elsewhere, have discovered the attractions of stock ownership; and extraordinary advances in information technology have helped to break down some of the technical barriers to the free flow of capital.

What all of this means is that massive sums of capital can move toward your company, or away from it, in the blink of an eye. As economists predicted as far back as the nineteenth century, when capital *can* flow, it *will* flow. What we are witnessing now is the realization of that vision.

What are the consequences of these developments to corporate managers or to entrepreneurs who seek to raise capital? Very simply, it means that they must convince investors and lenders, who now have a virtually limitless array of investment opportunities available in markets all over the world, to invest money in their firms. To be most effective, this persuasion must draw on the power and tools of marketing.

While this point seems obvious at first, let's consider the practical effects of it. Thanks to recent capital market developments, investors can put their money practically anywhere. Just as companies must convince potential customers that they offer a superior value proposition compared to competing firms, or else customers will take their business elsewhere, companies needing capital must do likewise for investors; they must compete for capital. Part of this requires marketing their cases effectively to the right capital providers. But unlike commercial markets, in capital markets the firm needing money doesn't just do battle with its industry competitors.

Modern finance theory tells us that investors seek the highest risk-adjusted returns from their invested capital. Notice that they don't seek the highest gross returns. If that were the case, no one would invest in conservative, mainstream companies. Instead, they seek the highest returns on a risk-adjusted basis. Finance professionals normally define this risk in terms of stock price volatility, although the basic principle applies also to companies that aren't publicly traded. Simply put, investors want the highest returns possible for a given level of risk or price volatility, or the least risk or volatility for a given level of expected returns. This means that when companies compete for the loyalty of investors, they don't compete only in their industry; they compete against all other companies of comparable risk.

In fact, the challenge is even more daunting. Investors can temper the volatility of a high-risk company by adding low-risk investments, such as government bonds, to their portfolios. For example, an investment in a risky, high-tech venture, when combined with U.S. Treasury bills, may offer the same net risk profile as Procter & Gamble. If that investment combination is thought by investors to offer the prospect of higher returns than P&G's shares, investors will naturally prefer that alternative. In other words, Procter & Gamble doesn't compete for capital just against Johnson & Johnson and other important sector players; it also competes against firms in a broad range of industries, and not just firms with a similar risk profile. And with the increasing globalization of the world's capital markets, the competition for capital is played out on a worldwide stage.

Complicating matters even further is another key difference between capital markets and commercial markets. Capital markets (more specifically, stock markets) have players with no real interest in the product per se (in this case, companies). These speculators trade with no interest in the subject companies except to capture profits from short-term price movements. In many markets, these speculators can account for most of the trading in stocks (although rarely do they account for most of the ownership). This creates an important, and confusing, source of noise that garbles the message the capital markets are sending to companies on how their performance and future potential are perceived.

For a publicly traded firm, the stock market is the single most important source of information available about what investors think of it. In the world's largest exchanges, the market sends messages continually, combining investors' expectations of the future with reaction to news and rumors. In short, the market is both predictive and reactive. While it reacts to the events of the moment, it also anticipates the future—sometimes accurately, sometimes not. Also, stock exchanges are notoriously fickle, with price movements often the result of fads, moods, euphoria, or panic. But as the legendary investor Warren Buffett says, "Value will out." This means that, sooner or later, the market sorts through the information and noise, and rewards those companies with the greatest potential for generating shareholder wealth.

WHAT INVESTORS WANT

The guiding principles of investment decision making are (1) more benefits, in the form of profits or cash flow, are preferred to less; (2) near-term benefits are preferred to more distant benefits; and (3) safe investments are preferred to risky ones. Although it's easy to fall into the trap that somehow the basic principles of investment are different in start-up ventures than in large, mature companies, these principles apply to all investments, in all markets, and for all investors. As we show in the next chapter, however, the ways in which the essential features of this framework are applied will vary according to the stage of a firm's development as well as other factors.

When someone invests capital in a business, any business, that investment invariably takes the form of cash, or at least something that is convertible into cash. To illustrate, suppose a company's share price is $50, and that a particular investor owns 1,000 shares. By phoning his (or her) stockbroker, the investor could convert those shares into $50,000 of cash. Why doesn't he? The logical answer is that he believes, rightly or wrongly, that by holding on to the shares he will receive cash from the investment in the future that has a present value equivalent greater than $50,000. If he didn't believe this, the only logical course of action would be to bail out of the company and put the cash somewhere else.

This simple example points out several important lessons about capital markets and how customers in capital markets (i.e., investors) go about the business of deciding where to invest their resources. First, it shows that the value of any investment is based on the future and not the past. If investors have cash tied up in the company today, which must be true because their investments can be converted into cash in the present simply by issuing sell orders to their brokers, they do so because of expectations that they will receive more cash in the future by hanging on to their shares. The past still matters because it helps investors to form expectations of the future, but ultimately it is only expectations of the future and not realizations of the past that determine the value of any company.

The second key lesson is that value is based on capital market expectations of performance. The practical consequence of this lesson is that value is driven by the beliefs of investors and potential investors. A company can be blessed with the world's best managers and value-creating strategies, but unless the capital markets believe it there is no value creation. When it comes to valuation, if the capital markets don't believe it, it's not true. This fundamental reality points out the central role of communications in affecting market perceptions of value and risk.

Third, because investors tie up cash in the present, it is the prospect of getting even more cash in the future that gives companies any value at all in the capital markets. This is why finance professionals place so much emphasis on cash flows. Companies have value precisely because they can deliver cash flows to investors in the future. Those companies that are not perceived as having that ability are unable to raise capital.

More specifically, the cash flow investors care about is called "free cash flow." It's normally defined as a company's operating cash flows (i.e., the cash generated from its day-to-day business activities), net of whatever investment is required to sustain and grow these cash flows. The remainder, or free cash flow, represents the amount of cash that the company will then be able to give to its shareholders, bankers, and bondholders. In other words, it is the cash flow left over, after investment, for distribution to capital providers. Because capital providers invest in companies precisely because of the prospect of future cash rewards, and free cash flow represents the cash the company will be able to give back, the value of any business must be a function of its perceived ability to generate free cash flows in the future. This does not mean that free cash flows have to be positive this year, or even next, for a company to have value now. It only means that investors must believe in the company's ability to generate positive free cash flows in the future. If investors do not believe this is possible, to them the company has no value now.

The fourth, and final, lesson this example teaches us is that because any cash flows that a company might provide its investors will appear in the future, all such cash flows must be discounted. The discounting process, which reflects both the time value of money and the risk that the expected cash flows might not materialize, allows investors to convert a stream of expected benefits (to be received at different points in the future) into a common point of reference called the present value equivalent. In short, future free cash flows are discounted by a cost of capital, or interest rate, that reflects the rate of return that investors would expect if they invested in another company of similar risk.

As we show in the following chapter, while the basic aim of investing is the same for any investor, namely the highest risk-adjusted returns on capital, the cast of characters changes dramatically as companies make the transition from private to public ownership. Logically, therefore, publicly traded companies market themselves differently than start-ups or growth companies that have not yet gone public. For example, the market for venture capital or angel investing is of little or no interest to Cola-Cola or Intel. Instead, their sales efforts in the capital markets are targeted mainly at large institutional investors in the mutual fund, pension fund, and insurance industries.

While the dominant motive for investing is the desire to earn competitive returns, there can be other motives, too. For example, some investors in start-up or early-stage investments are attracted by the opportunity to play a role in the entrepreneurial process. They may have been successful entrepreneurs themselves, and welcome the chance to play that role again. The free time and financial security provided by earlier successes gives them the means to do this. Altruism can play a part, too, especially for investors who want to "give something back" to their local communities or hometowns. They may hope to stimulate investment or entrepreneurial activity in the region by offering capital and expertise to budding entrepreneurs. But while these motives can sometimes play a role in the allocation of capital, their importance is overwhelmed by the desire of capital providers to earn the highest risk-adjusted returns possible on their capital.

Although the world's capital markets are bigger than ever, the competition for capital has never been greater than it is now. With so many businesses competing for this capital, the process of raising capital has become as much of a marketing function as a finance function. Logically, therefore, the key elements of marketing come into play. For example, “know your market.” This means understanding who your best prospective investors (buyers) are, what they want to know, and what sort of investment opportunities they look for. Trying to sell a security to the wrong prospective buyer is expensive and wasteful, particularly when the range of tastes for securities covers virtually every kind of company and every kind of industry.

Another tenet of marketing is to “know your product.” This means knowing every aspect of what your business has to offer investors. What can you offer them, in terms of risk-adjusted returns, that other investment opportunities cannot? In order to compete successfully for capital, any company must be prepared to demonstrate—clearly, forcefully, and honestly—those factors about itself that indicate why it would be such a good investment.

Another tenet of marketing is to “know how to communicate effectively.” One of the authors attended an investor forum where would-be entrepreneurs had 10 minutes each to explain their business concepts and risk-return prospects. Half of the presentations were so poorly done that they didn’t stand a chance, however good their business concept might have been.

Today, managers talk about creating a value proposition for their customers. They must do likewise for their capital providers. In short, they must convince investors that their business offers a superior risk-return profile (i.e., a superior value proposition) to alternative investment opportunities (i.e., competitors).

TRENDS IN RAISING CAPITAL

Capital markets have undergone profound changes over the past generation, and we are confident that they will continue to do so in the future. Anyone hoping to raise substantial amounts of capital these days should have at least some understanding of these changes and the trends behind them. The most important trends include globalization, technological advances, financial innovations, changes in savings and investment, and dominance of institutional investors.

Globalization

Capital markets are now global. This trend has been spurred by a number of events and circumstances, beginning with the gradual disappearance of exchange controls in the 1970s. Throughout the 1980s and 1990s, deregulation was the major contributing factor. Today, capital tends to flow to countries where the risk-return trade-offs are attractive and restrictions on inflows and outflows are small. As countries have opened up their markets to foreign issuers seeking capital and to foreign investors seeking outlets for their investment dollars (or euros or yen), companies and investors have responded with massive capital flows. In turn, countries now find it hard to maintain highly restricted capital markets because the key players can avoid these restrictions simply by doing business elsewhere.

In one important area, however, regulation has actually increased. Where previously regulation was designed primarily to stifle markets, more recently policy makers have striven to make securities trading a fairer game. As a result, insider trading rules have been strengthened, especially in Europe where, until recently, insider trading prosecutions were extremely rare. Also, recent accounting scandals notwithstanding, corporate disclosure requirements have increased, making it easier for investors to track and compare the performances of publicly traded companies.

Large multinational corporations routinely raise debt and equity capital outside their home countries, but these days even smaller companies are moving beyond their home country borders to lure investors. This trend is largely a positive one because it gives companies access to much broader pools of capital, and it also allows companies to take advantage of differences in taxes and regulations across countries, thereby lowering their cost of capital. However, globalization also means that companies compete for capital not just against industry or national rivals, but also against investment opportunities outside their home markets. The increased fluidity of capital can be both a benefit and a curse.

Advances in Technology

The most important reality of today's capital markets is that huge amounts of capital can flow from one company to another, from one instrument to another, and from one country to another, practically in the blink of an eye. These capital flows would not be possible without the processing power offered by today's computer technologies. These technologies make it possible to simultaneously issue billions of dollars of securities in several countries around the world, to trade trillions of dollars of securities on stock exchanges and other trading platforms, and to efficiently price new instruments as they reach the market. We are now converging to a truly continuous, 24-hour global trading regime, at least for the equity of the world's largest, best-known companies. Eventually, such trading opportunities will extend to a much broader range of securities.

Financial Innovation

Globalization, deregulation, and information technology have spurred the creation of innovative financial instruments. Investment bankers have designed new instruments that allow companies to (1) tailor securities that appeal to a well-defined set of investors, (2) reduce the effects of fluctuating interest and exchange rates, and (3) convert illiquid assets into highly liquid financial instruments. The result is an astonishing array of financial instruments available in global capital markets.

An important example of such innovation is the growth of securitization, a trend that began to accelerate in the 1980s. This is the process of combining assets or financial instruments that are not securities, registering the combined, or bundled, units as securities, and selling them directly to the public. Securitization practically revolutionized the mortgage market in the United States by creating publicly traded mortgage instruments. The practice was later extended to cover a broad range of assets, leading to a whole new market in asset-backed securities. For example, companies can now sell their trade receivables, and raise much needed capital, at lower cost than before.

An interesting consequence of financial innovation is that it has helped to blur the lines that distinguish one type of financial institution from the others. For example, as we explore in Chapter 5, commercial banks aren't the only institutions providing commercial loans. Insurance companies, pension funds, and other investor types are in the business, too. Similarly, securitization and similar innovations have allowed other institutions to compete on turf that previously belonged exclusively to investment banks.

Changes in Attitudes toward Savings and Investment

While all of these developments took shape, a new generation of investors emerged, flush with cash and possessed as well of more favorable attitudes toward capital market investing than earlier generations. Aided by a seemingly endless bull market (interrupted by the odd crash, such as in 1987 or in 2000 with the collapse of technology stocks) and solid evidence that with a long enough investment horizon a person is almost certainly better off investing in equities than in government bonds or bank accounts, millions of people whose parents never even thought about buying stocks have taken the plunge and become shareholders. This trend was accelerated in Europe by privatization campaigns that sought to ensure the permanence of private ownership by encouraging dispersion of the shares of newly privatized companies among a large cross section of citizens.

Growing Dominance of Institutional Investors

Interest in stocks, and in investing generally, has grown in ways unimaginable to finance professionals as recently as the 1970s. The result is a veritable worldwide explosion in mutual funds, unit trusts, and other forms of institutional investment. Not only do many more people have a financial stake in companies, typically through mutual funds or pension funds, but of particular importance to corporate managers is that these funds are run by professional managers who care only about performance and delivering the highest returns possible to the people who hired them. There is little doubt that the explosion in pension fund investing over the past generation, and the growth of professional money management that came with it, is the single greatest factor behind the emphasis on shareholder value creation in U.S. companies.

This trend is beginning to intensify in Europe, too, thanks in part to its own mutual fund industry but also because of the growth of pension funds. With aging populations and an unsustainable safety net, a growing number of Europeans now recognize that underfunded social security programs will be unable to serve the retirement needs of today's workforce. To provide for the needs of an aging population, and to stimulate savings and corporate investment, many countries have implemented or are planning to implement pension and savings plans that will channel unprecedented amounts of equity capital to European companies.