# CHAPTER 1

# Finance for Start-Ups 101



An appropriate starting point for this book is a review of some basic financial terms and concepts that will be useful in understanding the principal themes to be found in the ensuing chapters. This chapter consists of seven sections: fundraising stages, risk/return, types of funding, capital structure, intellectual property, valuation, and exit strategy.

## Fundraising Stages

According to standard definitions, a company's fundraising stage is determined by a number of factors, including the number of employees, amount of revenues, capitalization, profit, and the status of product development. For purposes of this book, it is more accurate and useful to define a fundraising stage as a period during which the cost of funds, whether in terms of equity dilution or rate of borrowing interest, is comparable throughout such period. Reaching the next fundraising stage requires progression to the next stage of business development and/or attainment of the necessary financial objectives permitting the solicitation of additional capital at more favorable terms vis-à-vis a higher valuation or a lower interest rate that can be secured from prospective lenders. The significant implication is the derived value of raising funds efficiently via raising only the necessary funds in each funding round at the lowest cost of capital currently available to reach the next fundraising stage. Determining the "necessary" amount of funds and identifying the sources of funding currently offering the lowest costs of capital requires a financial plan.

This section consists of four subsections, beginning with the necessary preparation required during a prefunding period followed by the three successive fundraising stages: seed, series A, and series B.

## Prefunding Period

The prefunding period is the time between the conception of business idea and the organization of this idea into a business plan. A series of important questions must be answered during this stage:

- Is your idea a possible solution to an identifiable problem?
- Are you uniquely qualified to execute such an idea?
- Who would benefit from effective execution of your idea?

Without an affirmative answer to these questions, the idea, although possibly worthy and interesting, may not present a business opportunity for you and prospective investors. If you can answer yes to these questions, the next issues must to be considered:

- *How much development time is required for your product or service?* This consideration is particularly important in the fast-changing world of technology. If you expect it will take five years to develop something that would almost certainly be obsolete at the end of those five years, perhaps your business idea is not meant to be.
- *Do like-minded individuals/competitors exist?* If you and a partner want to attempt to do something a big company like Yahoo! has already decided to spend millions of dollars on for research and development (R&D), perhaps you are contemplating an overly ambitious endeavor.
- *How willing are you to pursue this business opportunity and accept all the inherent sacrifices and risk?* Are you willing to have a Ramen noodle lifestyle, living a meager existence in which all of your earnings or savings is allocated to funding the venture at the expense of other personal spending options?
- *Do you have considerable family obligations*, such as kids demanding your time, a spouse preferring a sufficient and stable income?
- *What if this business venture does not succeed?* How much have you risked? Is there a contingency plan for you?
- *What if it does succeed and requires heavy and extended duty?* Are you capable of making such a commitment?
- *Can you reasonably envision investors assuming the risks and potential employees sharing your passion?* Will others be willing to patiently share in your pain and suffering?

The main objective of this stage is to write a business plan that can provide answers to the first set of questions and offer a framework on how the idea can be executed.

## Seed Funding Stage

The seed funding stage is the first true fundraising stage occurring between the composition of a business plan and the completed development of a working prototype. The primary objectives of this stage are proof of concept through the development of a working prototype and protection of intellectual property (IP).

The development of a prototype has to progress to at least the point at which it can be offered on a trial basis to test users with the expectation that useful and actionable feedback can be collected. The prototype must be sufficiently presentable to prospective investors, who are primarily interested in determining its commercial viability.

Proof of concept is defined as being able to actually show a product or service to be useful to someone other than yourself and there is a waiting and prepared market for it. There are several ways to demonstrate proof of concept. The most common and effective proof of concept techniques include alpha/beta user testing, various customer feasibility surveys, and surveys based on Kano analysis. The latter effectively measures customer responses utilizing a practical and actionable customer preference classification system.

During this stage, it is strongly recommended that you protect your intellectual property either by filing patents or by writing hard-to-replicate software.

The amount of seed funding to be secured is determined by the amount of funds necessary to develop a prototype to present to both prospective investors and test users, costs associated with conducting proof-of-concept exercises, and filing and other costs associated with protection of any intellectual property. Common seed stage funding sources include individual friends and family, angel investors, early-stage venture capitalists, public funding agencies, and private incubators/accelerators.

## Series A Funding Stage

The series A funding stage is when you evolve from being an R&D enterprise to being a business. The primary objectives of this stage are to begin generating revenue and validate the existence of your business through the execution of a successful commercial launch. Now is the time to implement your marketing plans, establish acceptable payment methods for your customers or users, formulate an optimal pricing policy, select the best channels of distribution, secure favorable arrangements with key vendors, and commence working relationships with any comarketing partners to demonstrate commercial viability to your investors, activities that go well beyond proof of

| Fundraising Stages | Stage of Development | Primary Stage Objective | Primary Use of Funds | Typical Funding Sources |
|---|---|---|---|---|
| Seed | Business planning<br>Research and Development | Proof of concept<br>Protection of IP | Developing and producing a prototype | Angel investors early-stage VCs<br>Public funding<br>Incubators<br>Friends/Family |
| Series A | Commercial launch | Prove commercial viability<br>Commence revenue | Execute commerical launch | Venture capitalists<br>High-net-worth angels |
| Series B | High growth stage | Profitability<br>Scalability | Building scalable infrastructure<br>Hiring operational personnel<br>Market expansion | Private equity firms<br>Strategic partners |

**FIGURE 1.1** Fundraising Stages

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concept. Prospective investors will ask you to "show me the money." The best way to accomplish this is to point to paying and satisfied customers as well as mutually beneficial relationships with strategic partners.

From a fundraising perspective, the series A funding stage is the most crucial and tricky of all the funding stages. Up to this point, only a modest level of funds, if any, has been raised, and the investors, if any, are people who most likely provided funding to you based on personal trust. It is hoped that you have succeeded in accomplishing your seed stage objectives because now your fundraising efforts will likely be directed toward securing greater funding amounts from individuals and investment groups with a set of defined investment criteria and with whom you have no prior personal experience. The series A funding stage is the primary domain of venture capitalists.

### Series B Funding Stage

The series B funding stage is when your company needs to become profitable. The primary objective of this stage is to fund increasing growth in a sustainable manner and demonstrate exponential financial returns. For a technology company, this usually means having the funds necessary to staff support teams, achieve maximum scalability, and expand into new markets. The primary series B funding sources are private equity firms and strategic partners that find your product promising after your successful commercial launch.

The number one challenge entrepreneurs face during this stage is managing growth, which is one of the top reasons why most businesses fail. Failure to meet the explosive growth frequently experienced by successful tech start-ups has often proven to be the death kiss for so many promising entrepreneurial ventures. Securing sufficient series B funding to fund scalability of infrastructure and hire operational and support staff is critical to ensuring that this welcomed growth is supportable. (See Figure 1.1.)

In Chapter 4 we examine using strategic financial planning as a road map to navigate the successive funding stages.

## Risk/Return

An important concept to understand is the relationship between risk and return. The greater the perceived risk, the greater the expected return.

Factors considered by prospective investors that may increase or decrease their perceived risks of investing in your venture include the time to realize returns, the amount of funds to be invested, growth prospects in

the market targeted, probability that the product will be commercially successful, and level of confidence in the capability of management in executing its plans. A primary objective of your fundraising efforts is to credibly reduce the perceived risk of investing in your venture to improve your chances of attracting an investor and secure the most favorable terms possible. The better you are in achieving this objective, the higher the perceived valuation of your company will be, thereby commanding a higher equity share price or lowering your venture's cost of capital at any given point.

At the earlier fundraising stages, the longer time to realize returns (higher risk) is somewhat mitigated by the comparatively modest amount of investment funds required. However, you may unnecessarily forfeit such risk mitigation if you solicit for more funds than needed to achieve your objectives in a given fundraising stage. Therefore an understanding of the risk/return relationship is vital in increasing the probability of success and efficiency of your fundraising efforts to ultimately maximize your returns.

Another aspect of risk/return to be considered is the relative risk/return for the founding partners. As mentioned, the earlier people invest, the greater their return in relation to their assumed risks compared to later investors. The founding partners, original investors who must put forth extraordinary efforts for a successful exit, earn the highest returns in proportion to the amount they actually invested. The founding partners assume four primary risk categories, which can be divided into quantifiable or nonquantifiable.

The quantifiable risks include:

- *Actual monetary investment*. This includes the actual amount of money or other tangible resources committed to the venture.
- *Financial opportunity cost*. This refers to the financial sacrifice assumed by founding partners to pursue the entrepreneurial venture. If a founding partner had to turn down a $100,000-per-year job offer, the opportunity cost equals the annual salary being forfeited multiplied by the years required to be dedicated to the venture. Opportunity costs are often the most significant but overlooked costs borne by a founding partner and should never be discounted.

The nonquantifiable opportunity costs (risks) include:

- *Blood and sweat*. The personal efforts, added stress, and other nonfinancial sacrifices or hardships need to be counted. If an outside investor invested the same amount of money at the same time as a founding partner, the founding partner's greater efforts than those of a more passive investor should be accounted for at time of exit.

- *Political capital expended*. The risks, added strains, and obligations placed on personal relationships and the professional reputations of the founding partners entitle them to a greater proportion of returns.

A successful exit strategy requires extraordinary efforts on the part of the founding partners that go well beyond their financial contributions. They should be awarded accordingly.

A proper understanding of risk and return is necessary to attract funding on terms of mutual benefit to founding, current, and prospective shareholders. In Chapter 2 we discuss the various risk mitigation factors that can be employed to reduce the perceived risk of your venture.

## Types of Funding

Equity and debt are the two primary types of funding from external sources, each with pros and cons and each with specific characteristics and ideal conditions in which they are to be sought. Internal (self-) funding is the best option if and when possible. Whether it is initial funding capital (founding capital) drawn from you and your founding partners' personal resources or capital funding allocated from generated revenue, internal funding will avoid incurring any obligations to external parties and establish your skin in the game—a demonstration of a personal financial sacrifice to be incurred if your business venture fails. Sacrifices include such things as opportunity costs, actual financial investment, placing at-risk personal relationships and professional reputations, assumption of stress, and time away from family. A value needs to be placed on such sacrifices when determining an appropriate share of potential financial returns. We illustrate the importance of establishing such perceived value in future fundraising efforts and negotiations with prospective investors.

The reality is that at some stage, you will very likely need to solicit funding from external sources either because you can't fund an immediate or planned specific need or you have insufficient funds to support projected or current growth. The types of funding to be secured from external sources include private equity, debt, alternative variations of both, several different public funding options, and incubator or accelerator programs that are either publicly or privately funded and managed.

### Private Equity

The most common way for your start-up company to raise capital funds is through the sale of shares in your company. In this way you are adding outside investors as additional business partners. This is the ideal, if not the only, way for early-stage companies to secure sufficient funds in a timely

manner. This type of funding has its pros and cons. An immediate injection of such capital can be used to fund rapid growth. Equity investors who receive common shares do not have legal claim to your tangible and nontangible assets if something goes wrong. To a large extent, their interests are closely aligned to yours: the ultimate success of the business. They are willing to share your risk so they may share your return. However, as voting shareholders, they will also want to share in company decision making. Passive investors, who do not want much direct involvement in the affairs of the business, are rare but ideal regarding the issue of control. The greater the percentage share of equity outside investors hold in your company, the less your potential control of the company. Control assumes many forms. It can be exerted through voting rights as shareholders, board membership, leverage that exists due to company's financial dependence, and numerous other sources. Issues of control are discussed further in later chapters. Another disadvantage of accepting more equity investors is the reduction of the founders' equity percentage in the company, which reduces the return they can expect upon the future sale or acquisition of the company.

## Debt Funding

Debt financing typically is made available by retail banks or specialized investment banks. During early fundraising stages, this type of financing may be difficult to acquire as the lending party requires minimum levels of cash flows to ensure that the borrower has the ability to make the debt payments (i.e., service the debt). Unlike the situation with equity investors, lenders will have claims on your tangible and nontangible assets (i.e., perhaps your core intellectual property [IP]) upon default. It is much more difficult to raise funds through sale of equity if you have considerable debt on your balance sheet because prospective equity investors prefer their funds be used for value-added activities, not paying off or servicing an existing debt. Prospective investors will also be cautious about investing in a company whose assets, especially core IP, has been secured by debt holders with more senior claims upon liquidation. A major concern for prospective equity investors is the risk of default on debt payments that can result in the loss of company control of to debt holders; it should be for the founders and other shareholders as well. A debt holder's interests may not be aligned with the interests of the company. Debt holders naturally are more conservative in decision making, as they are primarily interested in getting their principal returned and collect their interest earned in a timely manner. Therefore, they are more interested in cash flows (ability of your company to service the debt) during the term of the note than in making capital expenditures for the long-term success of the company. At the very least, it is annoying and distractive to have a debt holder opposing decisions that are being made in the best long-term interests

of your shareholders. Another con with debt financing is the possibility of losing control of company to the debtors in the event of debt payment default. Debt financing does have two distinct advantages: Debt holders do not have a controlling interest (i.e., shareholder votes) in your company, and the assumption of debt does not dilute the equity share of the founding partners or other shareholders.

Given the characteristics of both equity and debt financing, it is understandable why equity raises are more prevalent at the early stages. Once the company achieves the means to service debt (i.e., revenues), the risk of liquidation has been significantly reduced, and a future equity raise is neither foreseen nor necessary, it is preferred to end the dilution of equity and assume debt.

## Alternative Types of Funding

There are four specific types of funding that an entrepreneurial venture may encounter that offer a variation of debt and equity characteristics. They are convertible debt, equity warrants, factoring, and licensing/revenue sharing agreements.

### *Convertible Debt*

Convertible debt is a hybrid of both private equity and debt in which a debt note is executed and there are conversion terms. The investor usually is permitted to convert the remaining principal and possibly accrued interest balance into equity either at any time during the note term or only at the end of term.

Convertible debt is very favorable to the investor but may not be so good for the entrepreneur. Basically a convertible note is a dilutive debt instrument. It represents the best of both worlds for the investor and the worst of both worlds for the entrepreneur. In the event of liquidation, the investor enjoys all the protection afforded by debtor rights; if the company succeeds, the investor enjoys the returns of the higher-risk-taking equity investors. Until the note is converted, it remains debt on the company books, making it much more difficult to raise any type of debt or equity funding. Unfortunately, convertible debt has become a preferred way to raise early-stage funds. The primary reason cited to structure early-stage funding this way is the ease of raising such funds from a legal and pricing point of view. It may be true that in many countries, such as the United States, the legal fees and paperwork associated with a convertible note may be notably less compared to an equity placement. Also, by eliminating the need to value an early-stage company, as is necessary with an equity placement, funding negotiations can be conducted much more easily. However, as we discuss in great detail in Chapter 2, we are not seeking "easy" money; we are seeking "good" money. Making it

easier to secure "bad" money in which you become insolvent from day 1 makes it difficult to secure future funding and has initial investors see your future actions more through the lens of debt holders than shareholders who are sharing the same risks as the other founders. In my opinion, this is not a good trade-off. Until a funding round is reached whereby sufficient operational and financial objectives have been achieved to serve as a basis for a valuation, investors should be treated as founding partners; the percentage equity interest they are to be granted should be based on the factors presented in the risk/return section. During my extensive experience with entrepreneurial ventures, I have seldom witnessed an occasion where early investors felt slighted after a successfully concluded funding round. I have too often seen painfully protracted and costly funding negotiations for later-stage funding, if they do not doom the negotiations altogether, by a preceding debt placement. This can be particularly true for tech entrepreneurial ventures with valuable IP; the convertible debt holders typically and reasonably hold the IP as collateral, and later-stage investors who are considering investing a far greater amount cannot justify such a large investment if they have no claims to the IP from which future cash flows depend.

Entrepreneurs should not propose this type of funding structure to prospective investors. If a prospective investor, especially at an early fundraising stage, offers convertible debt, it should be approached cautiously. When we discuss financial planning and efficient fundraising in Chapter 4, we demonstrate why any type of debt funding should be delayed, if possible, for later fundraising stages and how to properly space funding rounds by determining the appropriate time to execute them. Doing this will help avoid slighting earlier stakeholders.

### *Equity Warrants*

A second alternative funding type is equity warrants, a substructure of private equity. Equity warrants grant the holder the right to purchase a specified number of shares at a specified exercise price. They may or may not specify a term. They share all the characteristics of equity with one important exception. A warrant holder does not have shareholder rights, particularly controlling voting rights, until such warrants are exercised. Once warrants are exercised, the warrant holder becomes a shareholder. Additional funding is generated (exercise price multiplied by the number of shares purchased) as well. Consequently, the higher the exercise price, the more favorable for the entrepreneurial venture and the less desirable for a prospective warrant holder. Equity warrants, when offered, usually are granted to comarketing partners and/or employees as incentives or to advisor/contractors for services rendered. They can be offered to attract prospective passive investors as well. The offering price of warrants is at a discount to the current market share price or at a mutually agreed-on price per share based on current valuation.

### *Factoring*

Factoring is a form of bank debt financing that is relatively unknown. Under certain conditions, however, it may be an attractive alternative funding option, particularly for entrepreneurial ventures. Factoring is basically a short- to intermediate-term bank loan that accepts an account payable as collateral as opposed to the tangible assets usually required as collateral for a traditional bank loan or both tangible and nontangible assets that must be pledged as security for a debt note from a private investor. To secure factoring credit, you will need to have an account payable or executed contract with either a client with a strong credit rating or a government agency and typically at least a 6- to 12-month clean payment history with them. The lender offering the factoring credit will provide funds to you up front based on a percentage of the total account payable or contract amount. The lender will collect the account payable or contract payment(s) directly and, in determining whether to award such factoring credit, considers the creditworthiness of your client more heavily than the creditworthiness of your company. The beauty of factoring is that you are effectively leveraging the strong credit of your client to secure an otherwise unattainable bank loan at very attractive terms without providing your core assets as security. Therefore, it offers all the advantages of debt but without many of its drawbacks. It is not uncommon to see an entrepreneurial venture secure a nice contract or expand an existing one with a large client but needing up-front funds to execute its contractual obligations. This type of scenario may create an attractive opportunity to pursue a factoring deal.

### *Licensing and Revenue Sharing Agreements*

A licensing agreement will grant the investing entity some form of right to utilize one or more of your IP assets in exchange for either an up-front or recurring licensing fee. If a party is identified that would be interested in entering a licensing deal with you, the two most important considerations are: Who is this party and to what extent are they granted such rights? Obviously you do not want to grant licensing rights to a direct competitor or anyone that can damage your strategic positioning in any way. You do not want to establish a potential competitor by granting too much right of use either. However, licensing fees are nondilutive and enhance your balance sheet via increasing the value of the IP nontangible asset as it is now considered a revenue-generating asset. Having an executed licensing agreement with a prominent firm will lend enormous validation and credibility that will only help you in future fundraising activities as well.

A revenue sharing agreement has similar advantages. The investing entity will provide up-front funds in exchange for a percentage of a current or future revenue stream of your business. It is nondilutive and doesn't carry the risk that misuse can lead to a strategic disadvantage, as with a licensing agreement. However, a revenue share will consume some of your future operating

cash flow. A revenue sharing agreement represents a source of confidence from an outside party that can be favorably exhibited to future prospective investors as well.

## Public Funding

Public funding offers attractive funding types as an alternative to traditional private equity or debt placement. Public funding may be made available by government agencies with mandates to achieve certain business development objectives for their particular municipality. The three most common types of public funding are matching equity, loan guarantees, and grants.

### *Matching Equity*

Matching equity is the most common public funding program. The funding public agency matches the equity investment of private equity investors. Securing a matching equity commitment from a public funding agency will help you tremendously in securing a matching equity investment from a private investor.

### *Bank Loan Guarantee*

A public agency will guarantee a portion or all of a loan that a bank provides to you. This method significantly reduces or eliminates the risks the bank assumes in lending you funds, which provides a bank with a large incentive to lend such funds to your business. Unfortunately, because tech start-ups have insufficient operating history, erratic cash flows, and/or lack of tangible assets to serve as collateral, such firms rarely can secure loan guarantees.

### *Grants*

Securing grants from a public agency can be a little more difficult to accomplish than other types of public funding but offer several advantages. Grants are nondilutive and, if they are granted unconditionally, they basically are free money—the best form of funding. However, unconditional grants are rare. They require a lot of precious time and effort (i.e., opportunity cost) to both initially secure and maintain (i.e., preparing periodic reporting requirements). Conditional grants are more common; here you have to pay back the grant money once certain preagreed conditions are met. The grant money may come only in the form of a reimbursement for an already incurred expense, which is not useful if you need immediate funding. However, a reimbursement grant with no repayable conditions is free money; whenever possible, seek such grants out.

A great common benefit of all public funding is the added credibility associated with securing any form of government support. When soliciting investors in the private sector, the value of such support cannot be overstated.

### Incubator/Accelerator Programs

Recently the number of both public and private incubator and accelerator programs has increased significantly. This is a very positive development. Both types of programs provide the use of facilities, promotion, mentoring, exposure to prospective investors, and occasionally seed funds for start-up companies. An incubator or accelerator may demand in return a nominal equity share of your venture. The primary differences between the two are duration and intensity. Typically a start-up enters an incubator program for six months to a year and is usually free to proceed at its own pace. A typical accelerator program grants selected participants between 60 and 100 days to achieve a very ambitious list of criteria in preparation for an opportunity to pitch in front of prospective investors at the end of the program. Both program types offer a great way to avoid having to initially raise funds for non-value-added expenses, such as rent, computers, and information technology infrastructure. Sharing space, ideas, and mutual support with other start-ups and formerly successful entrepreneurs can be of enormous benefit to your development efforts as well.

The qualifications and cost for a start-up to be accepted into an incubator or accelerator program are minimal. However, acceptance into many accelerator programs is on a competitive basis. Given the enormous benefits at such minimal costs and risk, it is difficult to imagine why a start-up would not take advantage of an opportunity to participate in an available incubator or accelerator program. The search for and application to such programs should be one of the first considerations for aspiring entrepreneurs contemplating starting an entrepreneurial venture. (See Figure 1.2.)

## Capital Structure

A firm's capital structure is the composition of its liabilities used to finance (acquire) its assets. It is basically a summary of all a company's executed fund raises. For our purposes, stakeholders are narrowly defined as including both shareholders and debt holders. Their positions will be represented in your capital structure.

The capital structure of your company is of significant importance to your fundraising efforts. It serves as a point of reference in observing and managing the rate at which your company's equity is diluted, managing relations with current stakeholders, foreseeing any control issues, and as a basis for determining your price per share, given the company's calculated valuation.

During your fundraising efforts, you will discover that every serious prospective investor will demand to see an accurate and up-to-date capital

| Funding Type | Availability | Control Effect | Equity Dilution | Alignment with Shareholder Interest | Event of Liquidation | Effect on Founder/ ROI upon Exit |
|---|---|---|---|---|---|---|
| **Internal Funding** (via founder's financial contribution or generated revenues) | Sufficient personal savings of founders, retained earnings or revenues | Optimal effect: No forfeiture of control to external parties | None | Fully | Optimal effect: No obligations established to external parties | Optimal effect: No obligations established to external parties |
| **Private Equity** | Existence of interested investors | Granting of shareholder voting rights and possibly a board seat | Yes. Amount based on percentage equity share purchased | Very high as fellow shareholders | Common: No preference Preferred: Liquidation Preference over common | Dilution based on proportional equity percentage amount issued to nonfounder shareholders |
| **Debt Instrument** | Sufficient cash flows or tangible assets for collateral | Constraining effects of reduced cash to service debt payments | None | Potential inherent unalignment between debt holder and shareholder interests | Senior to all equity classes | Reduced by amount of principal and accrued interest remaining due upon exit |
| **Convertible Debt** | Either tangible or intangible assets (i.e., IP) as collateral | Combination of debt and equity control effects | Yes. Upon conversion | Potential inherent unalignment between debt holder and shareholder interests until conversion | Senior to all equity classes | Dilution based on proportional equity percentage amount issued upon conversion |

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|---|---|---|---|---|---|---|
| **Factor Financing** | Qualified accounts receivable as collateral | Constraining effects on cash flow and managing accounts receivable of key clients | None | Neutral | Bank factoring lender has already assumed accounts receivable as collateral | Slight effect on ROI upon exit based on exclusion of accounts receivable as an asset |
| **Public Grant** | Product/service matches investment criteria/KPIs of public funding agency | Constraining effects from compliance with eligibility and use of funds requirements | None | Dependent on degree stated company objectives and KPIs match | Claim to any payback terms | Only reduced by payback terms reaining due |
| **Incubators and Accelerators** | Meeting minimal admissions qualifications or competitive selection | Dependence on provided facilities. Accelerator participants need to follow strict work criteria and possibly grant some equity | Maybe a nominal percentage equity amount as a fee for participation | High alignment. Both program types designed to prepare participants for both immediate equity funding and eventual exit | Dependent on percentage amount and classification of equity granted | Dependent on equity percentage amount granted; usually a nominal percentage |

**FIGURE 1.2** Types of Funding

structure of your company. Expect investors to examine it with keen interest as it reveals much about the financial management of your company and will determine the funding structure type and amount they may be prepared to offer.

Throughout the various fundraising stages, you will need to refer to your company's capital structure to track the rate by which the company's equity is diluted by each additional equity sale. I call this rate the rating of equity dilution (RED); it is illustrated in Chapter 4 on financial planning. An awareness of RED will allow you to efficiently determine the timing, size, and offering price of your equity sales.

Current stakeholders will follow the changes in the capital structure closely as well. They do not want to see a new investor—who as a later investor is theoretically assuming less risk—granted proportionally better terms. In Chapters 4, 7, and 8 we discuss the various means to maintain the integrity of a capital structure.

It is important for entrepreneurs to monitor the equity positions of each stakeholder to avoid fundraising activities that may grant a particular stakeholder or a group of stakeholders more control and potential influence than desired. It is also necessary to account for proxies. A proxy is a stakeholder that permits another stakeholder to wield its voting rights or other means of influence. Maintaining effective control of your company is critical, particularly in the earlier stages of development. Throughout all stages of development, it is important to avoid too much financial dependence on any one funding source.

For these reasons, maintaining a clean and healthy capital structure is critical. A clean capital structure is one that is not complicated by numerous funding types and convertible instruments that can be sources of confusion for prospective investors. For example, a convertible note can "dirty" a capital structure by injecting a level of uncertainty. If and when the convertible debt holders decide to convert, the company's capital structure may be substantially altered with the consequent reduction in debt and the occurring dilution of equity. A clean capital structure also demonstrates a fair progression of fundraising in which the earliest investors, who are theoretically assuming the most risk, enjoy proportionally higher returns upon the acquisition or sale of your company. A healthy capital structure is defined as one that does not impede the company's future fundraising efforts. For example, a large debt note secured too early may cause difficulty in offering a subsequent equity placement for reasons presented earlier in this chapter.

Most important, your capital structure will serve as a determining factor in deriving your price per share. Your company's capital structure, which represents the sum of your outstanding equity securities, is a direct factor in formulating the price at which to sell equity shares.

## Intellectual Property

Consider this truism: Ideas are cheap.

An idea in itself has no tangible value. If a commercial application for its use is identified, it has potential value as it can attract potential licensees. However, such nominal value is likely to be insufficient to attract high-risk investors. The value of any business is not the idea or product from which the business is built; rather the value is in the formulation and successful execution of a business plan associated with such an idea or product that generates exceptional returns for all its stakeholders. The greatest misperception by far I witness entrepreneurs have toward venture capital is the notion that a good idea or product is sufficient to attract investors. A venture capitalist will tell you it is all in the execution. If you have an amazing product but have a poor management team, implement a terrible pricing policy, or proceed without a financial plan, your venture will fail. If you have a not-so-spectacular product but have impeccable timing and make all the right decisions, you can make a fortune. I know people who have made an incredible amount of money selling outhouses to construction companies and others selling T-shirts. Not exactly flashy or innovative products, but the businesses were effectively planned, timed, and executed. I offer these examples to prove my point that ideas are cheap. However, the ideas or product originating from an innovative entrepreneurial venture have much more potential value than outhouses and T-shirts as they might change the lives and workplaces of many more people; thus, they have the potential to attract investment funds. With that said, there are numerous examples in the past 20 years of truly innovative ventures based on brilliant ideas that have failed to monetize their product or service.

For many entrepreneurial ventures, the most valuable asset they most likely possess is nontangible. It is their IP. IP can be defined as any innovation created through one's own original thinking and experimentation that may offer the possibility of securing legal property rights for the inventor. It is a nontangible asset because it is neither a physical object nor quantitatively valuated due to its original nature. Nevertheless, potentially significant value may be derived from the opportunity to utilize such IP to develop and produce a product or service that is revenue generating. The greater the number of commercially viable applications of a set of IP, the more valuable it potentially is as well. An entrepreneurial venture's IP often consists of several related innovative creations referred to as a suite of IP. Much of the initial fundraising activities of an entrepreneurial venture and the basis for its capital structure are funding the development and protection of its IP suite.

A primary objective of any entrepreneurial venture is to protect and maintain control of its suite of IP for as long as possible. The extent

and means by which IP rights are defined and protected vary from one legal jurisdiction to another. Entrepreneurs can legally protect their IP in five formal ways:

1. *Patent*. A patent is a set of exclusive rights granted for a specified period of time by a legal authority to the owner of IP, as defined by the legal authority, in exchange for the public disclosure and commercial availability of the IP. Typically, the patent applicant must demonstrate the originality, utility, and commercial application of its innovation. A patent holder may license to another party the right to conditionally utilize its protected IP. The purpose of granting patents is to encourage innovation by providing a financial incentive to inventors to publicly introduce their innovations for the public's benefit.
2. *Copyright*. A copyright is a set of exclusive rights granted for a specified period of time by a legal authority to an author or creator of an original work with the potential and possibly intention to be copied or mass distributed. A copyright gives the grantee the right to copy, distribute, and adapt the protected work. As with patents, a copyright holder may conditionally confer such copyrights to another party.
3. *Trademarks*. A trademark is a distinguishing attribute (i.e., sign, logo, etc.) that is readily identifiable with a unique source (i.e., your company, product, or service). Successfully filing for trademark protection confers exclusive rights to the trademark holder to use its protected trademark to maintain public recognition of the connection between a company and its products and services. Such property rights may prove valuable when it is time to market and build brand recognition of your innovative products or services.
4. *Industrial design right*. An industrial design right is an IP right intended to protect an original and innovative visual design having aesthetic value. Typically an industrial design is used to produce a product.
5. *Trade secrets*. Trade secrets (i.e., classified or confidential information) are not formally protected other than via a confidentiality or nondisclosure agreement (NDA). A trade secret is generally not readily understandable, offers an economic benefit to its owner, and is worthy of maintaining its confidentiality. Trade secrets may include any processes, formulas, designs, practices, or instructions that meet the aforementioned characteristics. Basically your trade secrets represent the sum of all your mental efforts and experimentation to develop your product or service and from which your assets derive value.

Regardless of whether you formally protect your IP through a patent or through an executed agreement, such as an NDA, the best protection is the originality of your creation. The strongest protection is having the unique

capability of profitably utilizing your innovation. Before filing for expensive formal IP right protections and selecting the prospective investors you will be sharing your IP with, you must consider three issues:

1. *The level of necessity and value in pursuing IP protection*. Often it is not necessary to protect an innovation no matter how innovative it is. Ask this important question: *Is there sufficient value to justify protection in terms of the potential revenue generation to be derived and the strategic value it represents?*

   Obviously, if an innovation is the basis for the potential financial success of a product or service, it warrants serious consideration for legal protection. An innovation also may need protection based solely on its strategic value. If a certain IP is critical to differentiate and give you a competitive advantage, protecting it legally may be a good idea. A patent or any other type of IP protection is an asset that likely increases your valuation and provides a source of leverage in funding negotiations as we discuss in Chapter 6 on negotiations. Occasionally protecting an IP is advantageous as a preemptive strike to either prevent a potential competitor from acquiring exclusive use of such IP or to establish a barrier of entry into a given market. The latter serves as a risk mitigation factor that prospective investors find desirable, as we examine in Chapter 2.

   However, there are costs and risks associated with attempting to protect your IP.
2. *Cost, time, and effort required*. In most places in the world, filing for many forms of IP protection can be expensive. Filing for a patent in the United States, for example, could cost in excess of $10,000. This is not to mention the time and effort to complete and wait for an application to be approved, and there is no guarantee that an IP filing will be successful.
3. *Cost to legally defend*. Your IP rights are secure only to the extent of your ability to legally defend such rights. If you do not file for protection, your IP may become known only by those you allow to see it. Once you file for a form of IP protection, your IP becomes publicly available. No one is physically prevented from using IP that is legally protected. All the protection allows you to do is file for a lawsuit or court action for any violation. As a start-up, you may not have the means to detect and/or legally defend against such a violation.

## Valuation

Valuation is what a company is worth. How much is a company worth?

Your company and every other company is worth how much a prospective buyer is willing to pay to purchase the business. Ultimately the

valuation of a company is determined by negotiations between company and investors/acquirers.

The valuation of the company is the single most important thing that needs to be determined before an equity investment in your venture can be executed. The price per share at which an equity purchase will be consummated and the basis from which such investor's return on investment (ROI) will be derived will depend on the mutually agreed-on valuation of the company at the time of the equity purchase. A high valuation will make your investment opportunity less attractive to prospective investors; a valuation too low will reduce the eventual returns to be realized by founding investors and current stakeholders. The lower the valuation, the cheaper the purchase price will be for a prospective investor. Prospective investors know this and use all kinds of tactics to work the price down. In Chapter 6 on negotiations, we examine this in greater detail. For our purposes, suffice it to say that it is your responsibility and in your best interest as an entrepreneur to select the most appropriate, supportable, and advantageous valuation model.

Numerous valuation models fit into four general categories. The four general categories, listed in order from lowest to highest expected valuation calculations, are asset based, pro forma (projected financials) based, comparable based, and strategic based.

## Asset-Based Valuation Models

Asset-based valuation models place value on only those tangible and nontangible assets possessed by company. Basically these models are utilized to calculate liquidation values and do not attribute any value to the company's past efforts or future prospects except in the imperfect valuation of nontangible assets. Valuation of assets, both tangible and nontangible, is useful in debt placements requiring such assets as collateral. However, it is not appropriate for valuations of businesses that have accomplished anything that can be considered value added. Asset-based valuation models offer the lowest calculated valuations. Entrepreneurs should neither propose that their company be valued as merely a sum of its assets nor entertain a prospective investor who may offer funding based solely on assets. If you agree to an asset-based valuation, you are basically agreeing that you and your team have not added any value to the business thus far and do not offer any future value to the venture.

## Pro Forma–Based Valuation Models

Pro forma–based valuation models represent the most common type of valuation modeling for start-up businesses. The financial (pro forma) projections of a business are evaluated to determine a valuation. From these projections,

a company's profits and cash flows are drawn and revealed during a three- to five-year period. A valuation is derived from either a multiple of earnings or by one of numerous methods to discount cash flows. The multiple of earnings models will multiplies earnings before interest, taxes, depreciation, and amortization (EBITDA) by a reasonable factor based on the development stage and the industry. For a deal to occur, the investor has to accept your EBITDA and the multiple you are using. In discounted cash flow (DCF) methods, the projected cash flows are discounted back to their net present value. The discount rate to be employed is correlated with either the ROI or the annual internal rate of return (IRR) expected by the prospective investor. There exists much literature describing the various pro forma valuation models in more detail. For purposes of this book, suffice it to say that the numbers you place into your financial projections have to be supportable or at least reasonable and the valuation model you select needs to be recognized and ultimately accepted by your targeted prospective investors, and it must illustrate your business in the most favorable light. It is not a bad idea to try several different valuation models to calculate your valuation, given the same set of pro forma financials and see which one is the most advantageous.

## Comparable-Based Valuation Models

Comparable-based valuation methods attempt to value your company based on established valuations of companies similar to yours, often in the same industry and marketplace. Apparent differences in the businesses are used to adjust up or down the valuation of your business. Financial ratios such as price–earnings ratios may serve as a point of comparison. This method presents many challenges. Often your company is at an earlier stage of development than established businesses in your industry. Can you compare pro forma with actual financial numbers? Comparing a private company, such as your new entrepreneurial venture, to a publicly traded company with publicly available financial statements represents another potential challenge. A variation of a comparable method is a comparison of your business to the overall marketplace in which you operate. If a business in the same market was valued at $3 million when it was at the same stage of development as your business, perhaps a reasonable comparison can be made. That comparable business may also be currently trading at a price-to-earnings ratio of 10. Why not multiply your EBITDA by 10 to calculate your valuation, as opposed to the 4 multiple currently used in your pro forma–based valuation if you believe your prospective investor(s) would find such a comparison credible?

A comparable-based valuation model should be presented only to prospective investors who are very familiar with the industry or targeted market ("space") in which you operate. To be advantageous to you, the

calculated valuation needs to be higher than your pro forma–based valuation calculation as well.

## Strategic-Based Valuation

There are no specific models to discuss when considering a strategic-based valuation. It is more a matter of perception of a prospective investor with strategic intentions. The complementary, enabling, and enhancing characteristics of your technologies and products or business position are the considerations that will warrant the strong attention of a strategic investor. If you are fortunate or skillful enough to be in position to attract the interest of a strategic investor, you may receive the greatest possible valuation. This is the only type of valuation that considers ridiculously high valuations. In fact, financial projections and assets are often merely afterthoughts in the minds of strategic investors. Earlier we stated that the value of a company is how much someone is willing to pay for it. Was YouTube worth $1.65 billion when purchased by Google? It was to Google, but it was not to Microsoft. Google certainly did not use an asset or pro forma–based valuation method. Why did Google buy YouTube based on such a relatively high valuation? Basically YouTube provided a significant media platform through which Google could pursue its stated mission to organize global information in an easily acceptable and universal manner. This acquisition is an example of a strategic purchase based on complementary objectives and capabilities resulting in large returns for the sellers' shareholders. A recent investment banking client of mine has attracted many different strategic investors due to its enabling core proprietary technologies. Although the strategic investors operate in different markets from each other and that of my client, the client's technologies offer uniquely strategic advantages for each investor. For example, one prospective strategic investor perceives the technology as a driver for demand of its own technologies currently in its pipeline (development stages). Another prospective strategic investor sees the same technology as a means to improve the performance of a service it currently provides. A third prospective investor views the technology as a means to enhance the marketing efforts of a major product it is about to launch and to enter a new market with in a significant way. A combination of good fortune and careful positioning has benefited my client and presents several examples of how an entrepreneurial venture can possess substantial strategic value.

Determining which valuation model is most advantageous to you depends on your ability to understand your prospective investors and identify their intentions. Generally asset-based valuation models should be avoided. Pro forma–based models are the most common valuation models that provide the most supportable and recognized valuation methods. Comparable-based

models should be utilized when it is advantageous for you to do so and presented to prospective investors who can be reasonably expected to accept. A strategic investor is the most prized prospective investor offering the greatest perceived valuations of your venture. The primary objective and challenge of your business is to identify and position your business to attract such investors. In Chapter 2 we discuss ways to identify and approach strategic investors.

## Exit Strategy

A business's exit strategy indicates how and when shareholders receive their returns. When presenting to prospective equity investors, you must assume that they are expecting a future sale or initial public offering (IPO) of the business to award them for their risk taking and support. Proceeding with a high-risk entrepreneurial venture without an exit strategy is tantamount to going to war without clear-cut objectives to end the war. In either case you will not find much support. If your business objective is simply to generate revenues for the purpose of providing the funds necessary to pay for stable salaries or only offer services with little opportunity for explosive growth, you will have to target your fundraising efforts to prospective investors who would be satisfied to receive recurring returns, such as a dividend or revenue/profit share. In general, it is not easy to identify equity investors willing to accept only small recurring returns as numerous investment opportunities offer stable income with much less risk than a start-up venture.

Serious prospective equity investors will want to be presented with an exit strategy that states how they get their investment and profits, when, and how much. A business can propose several different plausible exit strategies as well. The "how" is usually answered in one of two ways: a future sale to an investor or company or an IPO (an initial listing of a business on a regulated public equity securities exchange). In proposing a direct sale or acquisition of your business, you will need to mention specific potential buyers either individually or as a class and why they would be interested in being a future purchaser. Including strategic investors as possible buyers in your exit strategy makes your investment opportunity much more compelling. The "when" is presented in number of years to exit. The sooner the exit strategy, the more attractive it is to investors. However, the exit date needs to be realistic and allow your business sufficient time to reach the stated objectives to place it in a position either to be an attractive acquisition or to execute a lucrative IPO. Typically, an expected exit strategy is between five and seven years. The "how much" is presented as either a projected ROI or an annualized IRR. The greater the perceived risk investors assume, the greater their expected ROI or IRR. Investors consider the assumption of risks to be greater

the earlier the fundraising stage they invest in and the longer they have to wait for an exit strategy to be realized. Typically, equity investors expect an ROI of about eight to ten times. In other words, if they invested $1 million, they expect to receive $8 to $10 million upon exit. To achieve the same ROI over a five- to seven-year period would require an average annual IRR of at least 80 percent. Your exit strategy must demonstrate such an expected return if you want to attract equity investors for your high-risk entrepreneurial venture.

The exit strategy is the end game for your business. The exit strategy you choose will determine what prospective investors to target, how to present to them, how you prepare your business plan, and how you formulate your financial plan. As we illustrate in Chapter 2, an investor's primary motivation is to make money. The exit strategy illustrates how it is going to be accomplished.

## Summary

This chapter presented the basic financial principles relevant to the topics discussed in this book. The financial principles examined include fundraising stages, risk/return, types of funding, capital structure, intellectual property, valuation, and exit strategy. The fundraising stages include seed, series A, and series B. They progress from funding a prototype, to a commercial launch, to expansion. The various issues and challenges faced by an entrepreneurial venture in each stage were examined. The relationship between risk and return was analyzed to provide a basis for understanding the expectations of prospective investors, managing fundraising efforts, calculating valuation, and formulating an exit strategy. We described the various types of funding to assist in determining the most favorable funding type to solicit in each fundraising stage, given both the financial and nonfinancial pros and cons of each type. The closely related concept of capital structure was then examined to demonstrate how useful it is as a point of reference for financial decision making and its effect on prospective investors' perceptions. A discussion of IP was especially relevant for high-risk entrepreneurial ventures. The multiple values of an entrepreneurial venture's IP were presented to assist in determining whether and how the IP is to be protected. The ways in which a company's IP can be a source of revenue and leverage were also discussed. Valuation was the next financial principle presented. An understanding of how an entrepreneurial venture's valuation is determined will serve as a basis for the determination of financial objectives and ultimately the construction of an effective financial plan. Only after these financial principles have been understood and considered can you determine an exit strategy to illustrate to

all current and prospective stakeholders how they can profit from their financial and nonfinancial commitments.

Achieving a successful exit is the ultimate goal of every shareholder. A successful exit requires both a firm understanding of the financial principles presented and the expectations of the various prospective investors. Knowing your investor is the topic of Chapter 2.