Does the Law Matter? Part IV

Early Stage Funding

Learning everything you need to know about early stage funding. Essential tips and advice every startup or small business should consider when raising finance.

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A Guide to Startup Funding

You’ve come up with an idea for a business? It takes a great idea to get started, but your vision won’t become a reality without startup capital – that initial infusion of money needed to turn your idea into something tangible.

The numerous financing options for startups can seem daunting, but take the time to explore all possible sources. With that in mind, here’s an introductory guide to sources of startup fundraising.

Some things you will learn in this eBook

- The pros and cons of common sources of startup funding
- Financing benchmarks
- Legal considerations for private investors

Introduction: Personal Financing, Debt Financing, and Equity Financing

Broadly speaking, there are three main fundraising avenues from which to choose:

- Personal
- Debt
- Equity

Many entrepreneurs will choose to use a combination of all three types. Before we take a look at the possible sources of raising capital, it's important to know the key differences between them.

Bootstrapping

"Bootstrapping," or more simply put, using founders' own money is straightforward and has clear advantages over financing your company using outside capital. However most entrepreneurs do not have the required amount of personal money to start or run their business.

Debt

Debt financing means borrowing money from an outside source (usually a bank, or from friends or family) with the promise of paying back the borrowed amount, plus any agreed-upon interest, at a later date.

Equity

Equity financing means raising capital by selling shares in your company to investors. Unlike debt financing, the capital raised isn't paid back. Instead, investors put money into a business and become partial owners of that business and are entitled to a share of the business' profits over time.

Stages of Financing: What's the Difference Between Seed and Series A Financing?

Seed Financing

The first benchmark is seed or startup financing. This refers to the initial money used to get the business off the ground. This money could be a combination of personal financing, debt and equity from friends and family, from a bank or from angel investors or venture capitalists (VC), although most VCs will invest at a later stage.

At this stage, a company will generally be at a pre-revenue stage and will often not have a product or service on offer, but will have a clear idea of the kind of thing they would like to build with the money.

The purpose of seed funding therefore is to help the company develop a product to fit its market niche. As the business begins to gain traction and demonstrates a proof of concept, together with the beginnings of a predictable revenue stream, the company may look to raise capital in a "series round."

Series A and Series B Financing

The second financing benchmark, Series A funding generally refer to more significant equity investments from outside third parties, commonly 10-20% stakes in the business. Commonly investments will come from VC funds that professionally invest in early stage companies, but also other private equity funds. Family and high net worth individuals may individually or jointly invest, depending on the size of the investment round or how "hot" the deal looks in the market. Series A financing generally has as its ambition; the desire to build a successful, profitable business that can survive on its own. The investment amounts in this round are larger than in seed financing, typically around USD 2 to 5 million in Asia on revenues of USD 1 million annually; and valuations of approximately USD 20 million.

This is not to say that debt financing does not occur at this stage. Although it typically won't be referred to as "Series A," which almost always concerns equity investments on a preferred share basis, some businesses may choose to raise capital at this stage through commercial loans and mezzanine debt.

As a company grows and requires additional capital, the subsequent rounds of equity investment through the issue of shares to investors are called Series B, Series C, and so on through to IPO.

This eBook will focus on the sources of seed funding only; basically that initial infusion of money needed to turn your idea into a reality.

Common Sources of Startup Funding

Now that you understand the three main types of financing, and with the various stages of financing in mind, let's focus on the common sources of funding available to startups.

Bootstrapping

Pros

This is often an ideal choice as it gives you full control of your business, forces you to work highly efficiently and carries no debt or obligation to a third party. Further down the line, when you look for alternate sources of capital, both investors and banks will see the value in your business, given that you believed in the idea enough to put "skin in the game."

Cons

Even the best-researched and well-run startups involve risk. So while you need to trust yourself, and take the leap, be sure to consider the risk of your venture carefully when investing your own money in addition to your time. If it turns out that your business does not make it, you will most likely lose all the money that you have invested.

Bootstrapping is self-funding your company through stretching your own resources and finances, for example, through your personal savings, redundancy money, selling your assets or by "downsizing." In short, you're starting your company with just the money and assets you (and/or your co-founders) currently have.

Bootstrapping is a great first option, and can at least get you through the initial stages of building your business. Unfortunately, many entrepreneurs don't have

much in assets or money, and if your idea is complex enough and you are looking to significantly scale your operations quickly, its highly likely you will need to bring in outside sources of capital fairly early on.

Friends and Family

Pros

This is a great opportunity to secure money to get your business off the ground. If one or a few of your friends or family are business savvy, bringing them on as investors transforms them into motivated advisors. Raising money from your personal network can also be a step toward securing money from future investors, because it demonstrates that you are grounded in a network of people who have already bought into your business plan.

Cons

If your business does not end up doing well, or your friends get frustrated waiting for returns, you may risk lost friends and strained relationships with relatives.

A common source of financing for startup businesses are friends and family. While it may be difficult to get a loan from a bank or independent investors, those who are close to you and believe in you are more likely to be willing to take a chance on your fledgling business.

When accepting money from friends and family, make sure that they:

- Know all about the risks and rewards.
- Are clear about whether the money that they have provided to you is an investment in exchange of equity, a loan or an outright gift.
- Are given fair and favourable terms on their investment either by giving them equity or favourable terms on a loan (for example a higher rate of

interest than they could achieve in a fixed rate investment like a bond or savings account).
- Have been informed of your expectations of the business.

How it works?

The money provided by your family or friends could be a gift, a loan or an equity investment in your business. Each have their own pros and cons, and each should be recorded in writing, and in many cases, a legal document.

Gifts

The great thing about a gift of money is that you don't have to pay it back! However you probably won't raise as much money as you would if you were offering a potential return on the money. Also, gifts can quickly turn into loans in the minds of friends and relatives should your business succeed. A signed document, even a letter saying the money was given to you as a gift will protect you down the road.

Loans

This is a great way for friends and family to invest because there are set repayment terms. Your friends or family will know how long it will take for them to get their money back (and at what interest, if any). Debt financing from friends or relatives means that you will probably pay a lower rate of interest than if you borrow the money from a bank or commercial lender (and you might even be able to borrow money interest free). As an added bonus, you may be able to negotiate more flexible repayment terms than a commercial lender would permit and it is less likely that your friends and family will insist on "default" provisions typically attributable to bank lenders which can force your business into liquidation in the event that you fail to repay. However, as with the downside of any debt financing, you will be tying up some of your business' cash flow in making the repayments.

No matter how informal you believe your relationship to be, in order to avoid any future disagreements, it is important to enter into an agreement detailing the terms of the loan.

"Promissory Note": Detail terms of a loan from a family member dragonlaw.io

Equity

Although you won't have to pay them until you make a profit or cash out, by offering equity, you are turning a friend or a relative into a business partner. Remember, shareholders have the right to participate in certain business decisions.

If you choose to offer equity in exchange to raise money for your business, you will need various documents to record the relationship between you and the new shareholder and to complete the issue of their new shares.

Bank Loans

Pros

Banks can offer you the option of short, mid or long term financing and therefore provide some sort of flexibility. If the terms of the loan are indeed flexible, you may be able to make the repayment at any time. Additionally, you retain control of your business since you do not give the bank a share of your business.

Cons

As a startup, unless you are willing to put up some collateral, obtaining a bank loan will be difficult. Even if you manage to do so, you will need to generate enough cash flow to cover the monthly repayments and interest payments, regardless of how well your business is doing. You will probably be asked to secure your loan against your personal assets. If you do, you risk losing these to the bank if you can't repay the loan, in addition to the risk that the company maybe forced into liquidation.

Another option for funding your startup is a bank loan. Unlike investors however, bank's want an assurance of repayment, and generally look for companies with some track record and credit. This will naturally be difficult for a startup to demonstrate. In addition, banks will usually ask for collateral to secure the loan. You should think carefully about how much risk you're willing to take on before you get a loan or give any personal guarantees.

Government Funds: Grants, Loans and Equity Financing

Many governments recognise that inadequate funding is often the most common stumbling block for startups. Those that want to be recognized as startup friendly have crafted a pro-business and supportive environment to help entrepreneurs get on their feet.

> An online search should direct you to your jurisdiction's respective government supported initiatives.

Both Hong Kong and Singapore offer government supported initiatives that provide equity financing schemes, cash grants, and loans. Of course, there are various conditions that need to be met depending on the type of funding you desire. Nevertheless when you start thinking about your options, it's useful to check whether you are eligible for any of these.

Private Investors

A popular way to obtain funding for many startups is through private investors. Two common options are:

- Angel investors
- Venture capitalists

Angel Investors

Angel investors are high net worth individuals who invest in very early stage companies like startups. If you manage to convince an angel investor that your business model is the next “unicorn,” she will provide you with the capital you need, in return for which you offer equity in your business, either immediately or at some time in the future (in the event that you choose to use a convertible note agreement rather than immediate issuing of shares). Angel investors expect to receive dividends when the company starts to make money but more importantly, to get a very significant return on their investment, typically a return of 6 - 10 times the amount that they have invested.

Have you ever watched “Shark Tank” or “Dragon’s Den?”

These popular TV shows are excellent examples of angel investing.

Previously, entrepreneurs had to rely on a wealthy relative to be their “angel.” Today, angel investors are organized in groups that share their knowledge, collaborate and actively seek great startups to back. Some are even “serial investors” and invest in many startups a year.

Angel investors will typically fund a startup at the seed stage of a company. The amount they invest is flexible – it could be a small amount to get you off the ground, or a larger amount. They are also very likely to make further investments in future rounds since they know that not all plans go exactly as expected and your business is highly likely to need further funding. While they can provide insight and

Pros

The major benefit of angel investors is that along with the investment, angel investors offer ongoing guidance, expertise, a network and advice. As experienced business people themselves, they can be great mentors. Also, as with all equity financing (and unlike debt financing), the angel investor will not expect any financial returns until your business is turning a profit. Many people underestimate private investors and tend to not reach for private investors as a first option thinking that they won't be willing to invest in their project. However, when they do agree to do so the benefits can be tremendous.

Cons

Novice angel investors may often request an unjustifiably large portion of your company. As an investor, they will no doubt have a level of influence and decision-making power in your company. Remember, they will want to protect and develop their investment, so you will have a responsibility to them.

advice about your business, their job isn't ordinarily to build up your company day to day.

Venture Capitalists (VCs)

A VC is essentially a professional firm that looks specifically for early stage companies to fund.

While angel investors will usually be individuals investing their own money, venture capital is invested by firms or companies that most often use pooled capital. They raise that money by offering investors a chance to take part in a fund that is then used to buy shares in private companies.

The job of VCs is to find businesses with high growth potential. VCs almost exclusively take equity stakes (shares) and will often demand a say in how your

company is run (for example, by way of a seat on the board), and in exchange for their involvement, expect a high return on investment.

The fact that business angels are using their own money and VCs are using other people's will naturally affect their capacity for risk. Therefore VCs are generally more unwilling to invest in very nascent startups unless the startup shows some really compelling promise or growth potential. That's not to say that VCs are not interested in startups at all, in fact more and more of them are playing the seed financing game and investing early in the hope to land the next Facebook!

Agreeing to venture capital investment means committing to bringing more people into your business, people who have a say in how it's run and whose job it is to help your business reach its potential. If you're not interested in this level of compromise, this might not be the right option for you.

How are private investments structured?

There are several common ways in which an angel investor or VCs may invest in your company:

Ordinary shares

The most straightforward and favourable to the startup. The startup and the investor will agree to a fixed cash investment, and the number of shares that the investor will receive in return. As a holder of ordinary shares, the investor will be entitled to dividends and to vote on company matters.

Preferred shares

More preferable to the investor, and more commonly seen in later "series" financing rounds, these are equity shares with special additional rights. For

example, unlike holders of ordinary shares, investors who get preferred shares may be entitled to a fixed dividend regardless of profit levels. Most importantly, in the event of a liquidation of the company, investors holding these shares receive their investment back before the holders of ordinary shares (who are often likely to receive nothing).

Convertible Note

A convertible note is short-term loan that converts into equity. Investors loan money to a startup, and rather than receiving their money back with interest, the investors receive shares in the startup's next round of funding, normally at a discount to the price paid by other investors in that round (typically around 15-20% less), based on the terms of the deal. In short, they are debt instruments backed by the equity of the company.

Simple Agreement for Future Equity (SAFE)

A private investor can invest in your company using a SAFE Agreement. It is a relatively new concept, and very similar to a convertible note, intended to replace convertible notes in some situations. Essentially, it is an agreement whereby the investor provides capital to the startup, and in return the startup provides a warrant to issue shares to the investor at a later time and upon a specific event, such as at the next round of funding.

While there are other options of finance structures, these are the most common. Each has its own pros and cons, and is applicable depending on the investor's needs.

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Legal Considerations: Private Investors

There are various legal considerations and documents involved when raising capital through a private investor. If an angel or VC wishes to invest in your company, and depending on the type of investment structure, you will need one or more of the following documents:

HYPERLINK "https://dragonlaw.io/onepager/term-sheet-(ordinary-shares)/?utm_source=ebook&utm_medium=offline&utm_campaign=earlystagefunding"Term Sheet

This document is a statement of the proposed terms and conditions in connection with the investment. In the case of seed investments, the term sheet is commonly prepared by the startup. Most of the terms in the document are non-binding, with the exception of certain confidentiality provisions.

HYPERLINK "https://dragonlaw.io/onepager/seed-investment-agreement-ordinary-shares/?utm_source=ebook&utm_medium=offline&utm_campaign=earlystagefunding"Seed Investment Agreement

This document sets out how a startup will sell ordinary shares to investors in order to raise funds and will most likely incorporate the terms agreed upon in the Term Sheet. The agreement records the parties' rights and obligations in the shares and the share allotment process.

HYPERLINK "https://dragonlaw.io/onepager/convertible-note-purchase-agreement/?utm_source=ebook&utm_medium=offline&utm_campaign=earlystagefunding"Convertible Note Purchase Agreement

If the investment is structured using Convertible Notes, this document will be required. It details the terms of the loan provided by the investor, including the provisions for the loan to be converted into equity.

HYPERLINK "https://dragonlaw.io/sgp/sgp/onepager/simple-agreement-of-future-equity-(safe)/?utm_source=ebook&utm_medium=offline&utm_campaign=earlystagefunding"Simple Agreement for Future Equity (SAFE)

This agreement sets out how a company will receive capital from an investor in order to raise funds, and in turn, will provide the investor with the right to acquire equity in the company at a later date and upon a specific event.

HYPERLINK "https://dragonlaw.io/legalguide/different-types-of-shareholders-agreements-35/?utm_source=ebook&utm_medium=offline&utm_campaign=earlystagefunding"Shareholders Agreement

Once the investor acquires equity and becomes a shareholder, this document will be required. It sets out the investor's (shareholders) rights and obligations. It will also include information on the regulation of the shareholders' relationship, ownership of shares, and clauses relevant to the privileges and protection of the shareholder.

HYPERLINK "https://dragonlaw.io/sgp/sgp/onepager/share-ceritificate/?utm_source=ebook&utm_medium=offline&utm_campaign=earlystagefunding"Share Certificate for the New Investor

The new investor will need a Share Certificate as evidence of their shareholding in the company.

Find all these documents and more with Zegal. It's fast and easy and tailored to your specific needs. By answering a few simple questions with the smart Document Builder, you can create and tailor these documents to suit your specific business, efficiently and economically. HYPERLINK "http://dragonlaw.io/register/?utm_source=offline&utm_medium=ebook&utm_campaign=earlystagefunding"Start a free trial.

Crowd Funding

Crowd funding is a relatively new method of raising capital, and its popularity is rapidly increasing.

Popular Crowd Funding Websites Include:

Kickstarter www.kickstarter.com

Indiegogo www.indiegogo.com

Rockethub www.rockethub.com

Crowd funding takes it name from the fact that your project is funded by members of the public, using their own personal funds. To start with, you sign up with an online crowd funding website where you propose the idea that you wish to see funded. People can then choose how much or how little they want to give you. Most crowd funding websites either use a reward based model, where people who invest in a new business venture are given some form of reward such as the product that is going to be produced, or an equity based model, where those who invest are given equity in the business.

Crowd funding

Pros

While promoting your business to investors, you will also essentially be marketing your product or service that you are offering. Crowd funding can also be a great market research tool, especially if you are not sure if there will be any demand for the product or service you are working on. If your company has a particularly successful campaign and you have managed to hit your target, this will definitely put you on the radar of VCs further down the line.

Cons

Check that crowd funding is legal in your jurisdiction and keep in mind that crowd funding sites are a competitive place to earn funding, so unless your product or idea is absolutely rock solid and likely to gain the attention of consumers simply through a description and some online images, you may find that it doesn't work for you. It also has the disadvantage that your fundraising plans are inherently made visible to the world at large.

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Which source of funding is best for you?

Fortunately, you have numerous options of funding to turn your startup dreams into a reality. Which option you select depends on your tolerance for risk, how much control of your company you're willing to relinquish and your financial projections. Investigate all possible sources of funding before you make a decision. Many entrepreneurs use a combination of funding sources to get the money they need to develop their business, so don't be afraid to mix things up and stay in the game.

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