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White Paper

An Introduction to Startup Financing and a New Approach to Attracting Capital Resources.

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Quick Tips:

- When seeking startup funding it is critical to understand what stage of maturity your enterprise has reached
- Be sure that the type and stage of funding you seek is in alignment with what funders are looking for
- Financing can facilitate growth but it often comes at the expense of reduced equity and corporate control

Important terms:

- Bootstrap stage
- Seed stage
- Startup stage
- Early stage
- Second stage
- Third stage
- Late stage
- Liquidation stage
- Mezzanine financing
- Bridge financing
- Angel investors
- Venture Capital
- Crowdfunding

From the author:

It is a fact, failures resulting from a weak business model, poor product offering or a lack of vision on the part of the founders are not as common as one might imagine. However, a significant number of new businesses do fail because of inadequate capitalization. While most early stage businesses recognize a need for startup capital, many do not have the acumen required to secure these important resources.

With over two decades of Silicon Valley startup experience, StartupFactory has first hand knowledge of the role that capital plays in the ultimate success of a new enterprise. It has never been more important for our clients and prospects to gain a fundamental understanding of how the arcane startup financing process works. Many otherwise bright entrepreneurs are not fully aware of the various forms of financing that are available for each stage of business maturity or growth. And, as availability of traditional sources of capital diminish; we recognize the need to introduce our clients and prospects to some of the new and dynamic changes that are just now taking place in startup financing.
Erring on the side of caution we offer this seemingly obvious reminder: Accepting startup financing in any form can result in diluted equity, diminished decision-making power, and a reduction in future rewards.

We have organized the following report into three general areas: (1) the stages a business travels through as it grows from startup through maturity, (2) the means by which a company secures funding at each stage, and from whom this funding may potentially flow, and (3) Crowdfunding, the new paradigm in capital financing.

Early Business Stages Requiring Startup Financing

Seed Stage

Seed stage capital is required to finance the early development of a new product or service. These early fundings may be directed towards product development, proof-of-concept, market research, or to cover the administrative costs of starting the enterprise. A true seed stage company has not yet established commercial operations. A startup in this phase establishes proof-of-concept by demonstrating a prototype (product or service) to potential customers and entices them to become sources of capital. The company's goal in this stage is to test the market, establish the viability of the business idea, and measure interest and attractiveness to investors.

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Third Stage financing facilitates expansion projects such as plant expansion, integrated marketing programs, the development of a large scale sales organization, and advanced product development.

Startup Stage

Financing for startups entering this phase provides funds for product development, some initial marketing and some administrative overhead. This type of financing is usually offered to recently organized companies or to those that have been in business for a short time, but have not yet sold their product into the marketplace. Startup companies in this stage have, often times, assembled key management, prepared a proper business plan, and have conducted due diligence on the market viability of their product or service.

Early Stage

Startups requiring "early" stage financing have usually been in business between 2-3 years and have launched the company. The management team has been established, commercial operations have begun and funding at this stage is often required to cover cash flow requirements. Financing in this stage also strengthens capabilities in the areas of manufacturing, sales, and marketing.

Traditional Business Expansion Stage Requirements

Expansion capital facilitates the expansion of companies that are already selling products or services.

Second Stage

Second stage capital financing facilitates the expansion of companies that are already selling products or services. At this stage a company raises additional equity capital to expand its engineering, technology platforms, sales, marketing, and manufacturing capabilities. Many companies in this stage are not yet profitable and they often use the financing obtained in this stage to cover working capital requirements, and to support organizational overhead, and inventory costs.

Third Stage

Third Stage financing, if necessary, facilitates major expansion projects such as plant expansion, integrated marketing programs, the development of a large scale sales organization, and new product development. At this stage the company is usually at or near break even or profitable.

Traditional Late Stage Financing Requirements

Mezzanine Financing Phase

Mezzanine financing is a late stage form of financing for startups and is often used for major expansion of the company. This type of financing can also fund an emerging growth opportunity for the company. At this point the company may not wish to seek an additional round of equity diluting investment and may prefer the hybrid form of financing that mezzanine debt/equity financing offers. In addition, entrepreneurs may still be unable to obtain traditional bank loans at this point. Mezzanine loan investors are able to obtain a higher degree of security than an ordinary investment in equity since their rights, as debt holders, are senior to that of shareholders.

Bridge Financing Phase

Companies seeking bridge financing are mature, profitable, and are enjoying expansion. This type of short term debt financing is provided for a company expected to "go public" within six months to a year. The funds are often used to finance various requirements prior to making a public offering or some other major restructuring event. Often, bridge financing is structured so that it can be repaid from the proceeds of an initial public offering (IPO). Bridge financing can also involve restructuring of major stockholder positions through secondary transactions. This is done if there are early investors who want to reduce or liquidate their positions. Bridge financing may also be conducted following a management change. This enables the founders to purchase back shares from former management and individuals (friends, relatives, associates, etc.) prior to the IPO.

Liquidation Phase

The business lifecycle tends to work like the cycle of life itself, even for the most successful of startup enterprises that have succeeded beyond their wildest imaginations. For those enterprises that have made it all the way, the questions of "how and when" to "cash out" may be inevitable. As startups enter this final phase, known as the liquidation phase, there will be no shortage of "investment banking" experts from Wall Street and Wall Street West offering their services and money to you. Great care must be taken at this stage–sell yourself dearly. Most liquidations occur via merger and acquisition, IPO, or leveraged buy-out.

Traditional Sources of Startup Capital Funding

As the world continues to battle its way back from the financial meltdown of 2008, and through the most severe global economic crisis since the Great Depression, entrepreneurs have had to adapt to the harshest financing conditions in recent history. Traditional bank financing for existing businesses has dried up for all but the most credit worthy of borrowers, and access to traditional sources of capital for startups is scarce. As such, it is important for startup entrepreneurs to understand that the conventional types of financing paradigms (that have served startups through the latter half of the twentieth century up until 2008) are undergoing dynamic changes. Much of this is due to global financial forces beyond their control.

We are now entering a New Age in the world of startup finance, where clear-cut methodologies for financing are growing scarce. Financing for startups is clearly entering a disruptive period. In a scramble for precious resources, a startup may find itself drawing on a hybrid combination of financing sources, and these sources may come into play in no set order. As a precursor to understanding the News Age of startup financing, we feel it is still important to become familiar with the traditional sources of and methods for seeking capital.

Seed Stage Financing

Seed financing for a startup enterprise is often the most difficult in that it represents the greatest risk to investors. This is the financing stage where the

Issuing a Private Placement Memorandum is not a go-it-alone process, and an experienced securities attorney will be required. Although exempt from SEC registration, a private placement is still considered a security and must meet certain regulatory requirements.

founders of the startup have usually been bootstrapping their enterprise from personal savings and credit cards. Reaching this point, founders realize the need for more capital. More often, the next round of financing is provided by friends, family and well known associates.

At this juncture, startups may consider Reg. "D" Private Placement Memorandums to raise capital from an initial group of "outside investors." Private Placement Memorandums or Private Stock Offerings represent the point at which the startup begins to exchange share ownership for needed capital. Private placement investors have evaluated these opportunities with an eye towards making a return of 10x-30x their investment, but they usually have no say in the management of the company. In addition, standards on investment return expectations for high risk capital can no longer be assumed due to the uncertain economic climate of today. Issuing a Private Placement Memorandum is not a go-it-alone process, and an experienced securities attorney will be required. Although exempt from SEC registration, Reg. "D" Offerings are still considered securities and must meet certain regulatory requirements.

Angel Investor Financing

Angel Investors often provide a required round of financing to startups that are on the early stage path to profitability. In many cases, startups have overlooked the category of angel investor for their financing needs. Some academics place angel investors in the seed stage category of capital sources and others identify angel investors as filling the gap between seed stage capital and venture capital. Angel investing is, in actuality, a hybrid between the two.

Angel investors are often affluent people such as successful entrepreneurs, who wish to stay involved with their industry by assisting the next generation of startups. It is not just money that motivates angel investors; providing needed and valuable guidance to management of the startup is gratifying as well. Startup founders need to take a close look at their own needs and requirements before entering customized agreements with angel investors as they may find themselves giving away more control over their companies than they really want to. Angel investors require a return on investment in the area of 20x-30x their initial investment. These investors are not interested in slow-growth or "lifestyle" businesses. They are after businesses that can grow at an annual rate of 40% or more. Unlike venture capitalists (VCs), many angel investors do not calculate Internal Rates of Return (IRR) and other measures of investment performance. Angels often regard these types of calculations as too speculative. Startups can also expect a changing playing field when negotiating return expectations with angel investors.

Angel Investors place a great deal of emphasis upon the selection of the entrepreneurs they choose to fund. Angels typically focus on factors such as the entrepreneur's enthusiasm, trustworthiness, and experience. Obtaining angel financing, or any financing for that matter, is akin to making any other high-ticket sale. Good first impressions play an important role with these investors. Angel investors are often pivotal in funding the seed stage or very early stage startup requiring an infusion of $500,000 or less.

Venture capital firms are rarely interested in such small investments. Some angel investor-backed companies go on to receive venture funding as a precursor to making a public offering and reaching industry leader status. Angel capital can "pave the road" toward venture capital, as lacking this key financing, many start-ups would not grow to the stage required to attract the interests of venture capital firms. However, unlike high profile venture capital firms, angel investors often stay "under the radar" to avoid being deluged with business plans and requests for capital. Most potential investments are introduced to angels by their business, professional, and personal contacts. Seventy-five percent of startup founders say an angel investor's active participation benefits the firm, so be sure to select angel investors who can contribute the relevant expertise –as well as capital– to your firm.

Venture Capital Financing

Venture capital is a source of financing that usually follows seed stage funding and angel investor funding that is utilized in the earlier stages of the startup's life. This type of growth financing is provided to high-potential, growth-oriented companies that require a substantial round of investment. The amounts are usually in excess of five-hundred thousand dollars and up to tens of millions of dollars or more. However, it should be noted that venture capital funding can occur at any time throughout the startup's initial phases prior to IPO. Venture capital firms bear a high degree of risk investing in startups, including a complete loss of their investment. As such, most venture capital investments are done in a pooled format, where several investors combine their investments into one large fund that invests in many different startup companies. Large pooled funds of VC firms can range anywhere in size from $25 million–$1 billion. The VC firm will generally take a seat on the Board of Directors of the startup and will take an active role in bringing their management experience to the company. Many VC firms specialize in certain industries such as technology, biotechnology, and health care where they bring deep industry expertise to bear.

VC's most often take equity positions in startup companies in exchange for their capital and expect annual rates of return of between 30%-50%. It should be noted, however, that rates of return in this category are subject to a wide variety of factors, not least of which has been the difficulty in raising pools of capital for venture financing over the last several years. VC's require high rates of return because, in many cases, their investments in startups are highly illiquid and require anywhere from 3-7 years to come to fruition through a favorable exit event such as an IPO, merger and acquisition, or a leveraged buy-out. It is critical for startups to perform their due diligence on VC firms before jumping into bed with them. While it is true that VC financing is difficult to obtain, it is probably a good idea to avoid VC firms with a long standing record of being "Vulture Capitalists".

Some VC's have no problem firing everyone in the startup, including the founders, and shutting down the company, if they determine there is a financial advantage (for them) to do so.

Traditional Sources of Late Stage Capital Financing

Late Stage Financing

As Startups move through the early and expansion stage of their lifecycle and approach the late stage of the startup phase, the degree of risk decreases for investors and so does the potential for return going forward. Entrepreneurs at this stage have become much savvier about finance simply because they have survived until this point.

Mezzanine Financing

Mezzanine is a form of late stage financing and is usually a hybrid of debt and equity financing. Mezzanine financing can be provided by commercial banks, but, often times, it is not. Startups seek out Mezzanine financing when they require funds for a major expansion but lack the collateral to put up for a traditional bank loan. Mezzanine funding is also provided for merger & acquisition opportunities, restructuring, special projects, or cash flow needs when other sources of capital are unavailable. Mezzanine financing allows the company to move forward without the business losing its control or majority shares, but it is expensive and will cost the startup anywhere from 14%-25% a year. In addition, mezzanine lenders have the rights to convert to an ownership position in the company if the loan is not paid back in time and in full. Mezzanine financing is generally subordinated to debt provided by senior lenders such as banks and venture capital firms. There is less risk and less return for investors at this stage. Typical Mezzanine financing is provided for a term of 2-5 years. Sources of Mezzanine Financing are varied and may include: Commercial Banks, Venture Capital Funds, Investment Banking Firms, Insurance Companies, Public Pension Funds, Mutual funds, and Institutional Investors.

Bridge Financing

Bridge Financing, as the term is used in corporate finance, is a debt form of financing for Startup Enterprises that can be used for several purposes including, but not limited to, the following:

- To inject small amounts of cash to carry a company so that it does not run out of cash between successive major private equity fundings.
- To carry distressed companies while searching for an acquirer or larger investor (in which case the lender often obtains a substantial equity position in connection with the loan).
- As a final debt financing to carry the company through the immediate period before an Initial Public Offering (IPO) or an acquisition.

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A burgeoning new source of financing is just beginning to emerge and is known as crowd-funding. It is our belief that this form of capital funding will represent a significant opportunity for startup companies going forward.

Bridge financing is short-term in nature, usually offered for 6-12 months. It is also referred to as "gap" or "swing loan" financing. Bridge loans are typically more expensive than bank loans in order to compensate lenders for the additional risks they are taking. Bridge loans carry interest rates of between 10%-15% and also charge points and other costs that are amortized over a shorter period of time, and various fees and other "sweeteners" (such as equity participation by the lender in some loans). Bridge loan lenders also may require cross-collateralization and a lower loan-to-value ratio. The proceeds from a bridge loan are often paid back from the longer term financing event, such as an IPO, which is expected to take place in the near future. Typical sources for bridge loans include the investment banks that are taking the company public, venture capital firms that specialize in this type of debt, financing arms of some insurance companies, and private lenders.

Introducing Crowdfunding

Here are a few points practically everyone agrees on:

- The most important job creators in the economy are small, high-growth startups.
- With traditional credit markets stalled from the financial crisis, startups are, in many cases, starved for capital.
- Millions of Americans would like to invest in these companies, but they can't because of obsolete securities laws from the 1930s.
- A few simple reforms could allow Americans to make modest investments (up to $10,000) in small businesses without tremendous risk.

A burgeoning new source of financing for startups in the seed stage phase is just beginning to emerge and is known as crowdfunding. It is our belief that this form of capital funding will represent a significant opportunity for startup companies going forward. We believe that crowdfunding has the potential for profoundly changing the landscape of global startup finance.

Although crowdfunding, (also known as crowdsourcing), has served the financial needs of charitable causes, bands, authors, and non-profit initiatives for some time, it was the financial crisis in 2008 that drove the need for a new paradigm in small scale financing for commercial endeavors. The idea behind crowdfunding is both simple and profound. Crowdfunding neutralizes the advantage of the powerful Wall Street Investment Banks by distributing the ability to invest and profit to the people.

To learn more about crowdfunding, ask for our article entitled:
An Introduction to Crowdfunding—the New Paradigm in Startup Capital Funding.

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