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Meeting Investors: Understanding Funding Structures for Start-ups

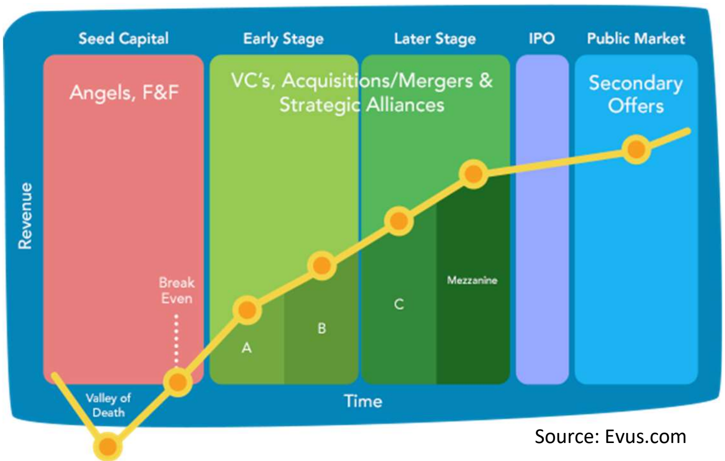
This publication outlines the various funding structures available to start-ups, and the key considerations start-ups should make in choosing a funding structure that works for their business.

Choosing the right funding for your start-up

Funding is often the primary constraint facing young start-ups today. However, there are several sources of finance that start-ups can rely on as they grow their business. This note discusses the main considerations for funding your start-up through equity, loans and convertible debt.

Equity

Equity is financing that is obtained through the **sale of shares** or ownership in the business. Equity financing takes two forms: public equity and private equity. Public equity involves the issuance of shares to investors on public stock markets, such as the London Stock Exchange. Private equity involves the sale of shares to private investors, such as FFFs (family, friends and fools), business angels (high-net worth individuals), accelerators, venture capital funds, private equity funds, and crowdfunding platforms.



Source: Evus.com

The type of equity financing raised by a start-up depends on the stage of the business and the amount of revenue it has generated. **Seed capital** is most appropriate for start-ups that are not yet making a profit and is usually comprised of common equity (i.e. equity held by founders and shareholders who have a claim to profits only after creditors and preferred equity holders) or convertible debt–i.e. loans that can be converted to equity at a later stage. Seed capital can be raised from FFFs, business angels, accelerators or crowdfunding platforms, and it ranges from £5,000 to £100,000. Some seed capital investors also provide business support, including mentorship, and business and technical advice. The UK Business Angels Association can be a useful source for start-ups looking for seed investment.

Once a start-up breaks even (i.e., when the revenues generated from the sale of products/services equals the costs of production as well as the costs of running the company), it can seek **venture capital (VC)** investment. The first round of VC investment is referred to as Series A funding, which typically involves an investment of up to £1 million to fund the scale-up stage of the business. Follow-on funding rounds provide capital to support further growth or to prepare the business for an **Initial Public Offering (IPO)**. VC investors generally provide hands-on technical support and require very high revenue growth rates (greater than 20%) to justify their investment. Therefore, it is important for start-ups to determine whether they are at the right stage of growth for VC funding, or whether they want to raise VC funding at all.

Once a company is generating large revenues, or has achieved enough scale, it can "go public" via an IPO. An IPO is the first offer of shares to the public on a public stock exchange. Although IPOs are complex, expensive endeavours, they provide businesses with an opportunity to raise funding from a much wider pool of investors. In addition, founders and initial investors can use an IPO to "exit" their investment. However, an IPO is not the only exit route. **Mergers and acquisitions**, or **private equity (PE) buyouts** in which PE firms buy the controlling stake of the business, are also a useful exit route for founders and initial investors.

Loan Funding

Debt is the most common form of outside capital for new businesses. While equity investors are very popular for funding among start-ups, it's the loan providers that are behind most of the investment that goes into the companies. Loan funding means you borrow money now and pay it back later, with an established rate of interest.

How it Works: generally, borrowing terms include the rate of interest applicable and the repayment schedule. The other important piece of the loan puzzle is collateral, which refers to some concrete or sellable property your lenders can take from you if you fail to repay the loan according to the agreed terms (e.g. if your business does not perform well). The more collateral you have, the better your chances of securing loans._.

EXAMPLE: to start a new luxury car dealership, Mr X is seeking $5 million in loans, which he will use to pay for his first round of cars to sell. In his loan terms, Mr X establishes that loans will be repaid with an interest rate of 10% per annum. As collateral for these loans, Mr X offers the cars themselves, as well as a mortgage on the property for the dealership, which he already owns.

When to use loan funding:

- **When you need little investment:** for small amounts of investment, giving up equity may not be the preferred approach. Furthermore, equity investors do not invest in small ventures unless and until the business idea is exceptional and highly likely to generate significant growth.
- **When you need the money for a concrete reason**: if your funding needs relate to physical infrastructure - for example, computers or other equipment - a debt raise is typically preferable. You will have your collateral readily available (i.e. the infrastructure itself), and you may give it as collateral in exchange for debt/loan funding.
- **When equity is not available**: often entrepreneurs are quite reluctant to give up equity in their company, and a straightforward debt raise has the attractive benefit of allowing you to retain ownership and control of your entity. If you are not ready to offer equity, a debt raise may be the right course of action.

Convertible Debt

Convertible debt (also known as 'convertible notes') is a loan which converts into equity later. The mechanism is simple: **instead of being repaid in cash, the lender becomes the owner of a certain amount of stock.** Principal and interest payments will accrue to then be used to buy equity at a maturity date, which for start-ups is usually the first round of VC investment. For this reason, convertible debt is recognised as a hybrid financing instrument.

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Convertible debt is useful to start-ups in their seed and early financing stages. In these stages, start-ups may need liquidity to thrive, but they may not have the credibility to be granted a loan by institutional investors such as banks (this situation is also known as the 'funding dilemma'). However, if the business has a meaningful growth potential, other types of investors (e.g. Business Angels) may be interested in lending money to the start-up, if they have an opportunity to share in its success in the future by converting their debt into shares. The support of such investors is crucial for the development of the start-up, as along with capital they provide their expertise in terms of strategical business advices.

The investors will have to pay a price for the shares. Being in an early or seed-stage venture, **it can be difficult to evaluate the start-up's overall worth** and **foresee the future equity value**, resulting in the business either underestimating or overestimating its value. This is especially true for tech start-ups, which have huge scale potential but are also subject to high risks and high failure ratios.

To manage this issue, **terms and provisions of convertible debt specify the conditions under which the conversion is going to happen**. The most popular terms are:

- the '**valuation cap**' (or 'cap'): it sets a maximum price for the equity when the conversion occurs. Even in a scenario where the business is thriving, the investor is going to pay no more than the agreed maximum price.
- the '**discount rate**': basically, the debt will convert into equity at a discounted price (usually 20% to 35%.) vis-à-vis that paid by other investors (such as VCs) in a funding round.

Key considerations for a start-up when it comes to deciding whether to raise funding through convertible debt are the **funding dilemma** and the **challenge of evaluating the worth of the business. Convertible debt may be the answer**, since it enables the **speedy creation of liquidity** and provides the start-up team with the **'wise' support of specialised investors**. This is crucial because the start-up is likely to face a VC funding round and needs to be prepared for it. On the other hand, due to its hybrid nature, convertible debt is a more complex type of funding. Thus, its terms and provisions must be carefully negotiated, read and understood by both parties.

	Pros	***Cons***
Equity	• Best for businesses that are not yet generating revenue or cash flow to cover debt interest payments • Suitable for technology-oriented businesses that do not have fixed assets to pledge as collateral for loans • Investors sometimes provide business or technical support in addition to funding	• Need to give up an ownership stake in the business (i.e. leads to equity dilution). • Less autonomy in decision making for founders • Sometimes requires businesses to achieve extremely high growth rates to justify equity investment
Convertible debt	• Provides liquidity when the business may not have credibility to be granted a loan • Provides the support of 'wise investors'	• Complex finance instrument. • Terms and conditions must be carefully agreed and negotiated between parties
Loan	• Interest on debt is tax deductible • Immediate cash support without reporting responsibilities	• Interest rates can be very high • No guarantee of loan approval from bank • The borrower should have ability to repay otherwise the loan request will be rejected

	• Once debt is paid back, there is no longer an obligation	

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