Funding New Venture

Capital is the lifeblood of an enterprise, as the old aphorism puts it, and want of it can be fatal.

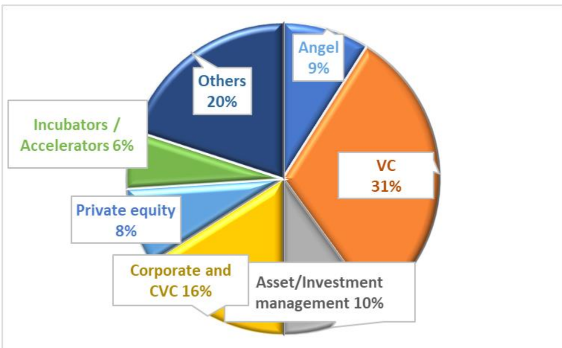
Fundraising considerations

i. When to raise funds?
ii. How much to raise
iii. Equity and dilution
iv. What types of investors to approach?

TYPES OF INVESTORS

- Bootstrap (self & friends)
- Incubators/ Accelerators
- Crowd funding
- Angels/ High Net Worth Individuals
- Early-stage VCs
- Venture Capitalists
- Private Equity Fund
- Public through IPO

Almost all startups need funds from external sources to grow their business. The requirement for funds increases as the business progresses. Several factors come into play when deciding how much, when, and in what form (equity, debt, quasi-equity, or mix) to raise funds. Ideally, one should raise funds only when the business is crying for it and as much as it is necessary to move to the next milestone. While failing to secure funds in a timely manner leading to the failure of many companies, raising too much money too early can lead to undue dilution of equity and a dangerous culture of extravagance.

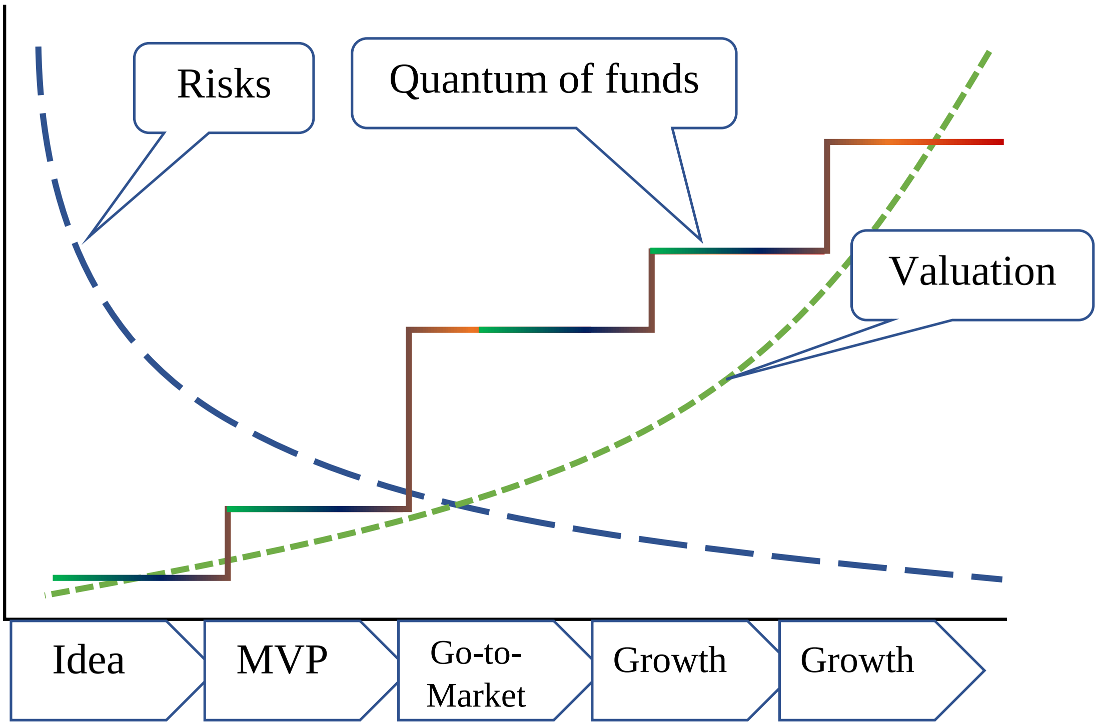


The second largest number of startups failures happens because of running out of fund. To put it another way, a large percentage of startups fail because they fail to raise money in time.

"Don't start a company unless it's an obsession and something you love. If you have an exit strategy, it's not an obsession."

– Mark Cuban

The startup journey is replete with uncertainties. As a startup builds its products, goes to market, acquires an increasing number of customers and grows the business, it tends to reduce the risk of failure progressively on its way. The quantum of funds requirement usually increases, so is the startup valuation. For example, at the idea stage, there are uncertainties of the success of an emerging product that customers may or may not buy and all other risks that a new venture would encounter. Many investors would avoid funding at this stage. As the company gets their product validated and moves forward, it will face other challenges. But it will now be more attractive to investors, and they will value the company higher.



Figures 1: Risks, quantum of funds and valuations during early life cycle of startups

Therefore, startups would approach high risk-tolerant investors at the beginning such as own money, family, and friends.

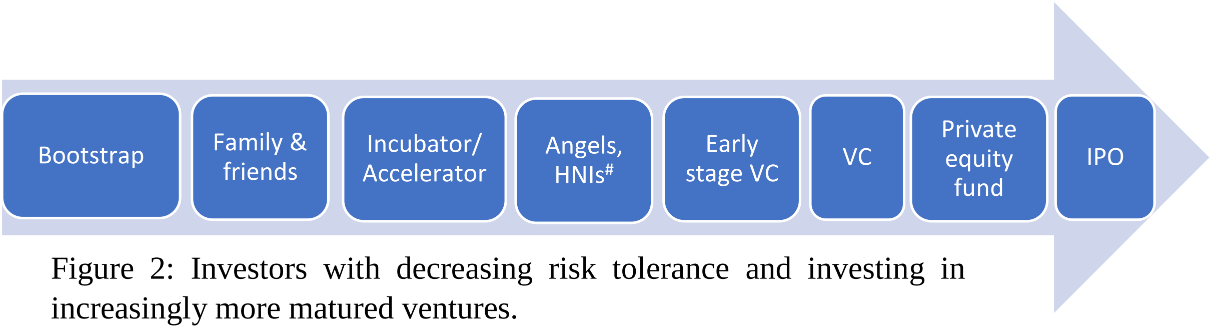


Figure 2: Investors with decreasing risk tolerance and investing in increasingly more matured ventures.
HNIs: High Net Worth Individuals

Equity dilution is an issue of concern at all stages of fundraisings. Let us have some introductory knowledge on the dilution process through an example. To that end, you have to try to understand the assets and liabilities of any venture. Liabilities, including equity, are the sources of funds and assets are where they are deployed. One can identify all the funds raised by a company in its assets. The first source of funds is the money brought in by the cofounders and is represented in the form of equity capital. Suppose three cofounders start a venture by investing a total of ₹ 5.0 lakh in equity capital as follows:

Aroon: ₹1.0 lakh
Baroon: ₹ 1.5 lakh
Daroon: ₹ 2.5 lakh

The percentage holding of the three cofounders are, Aroon: (1.0/5.0) *100 = 20%, Baroon: 30%, and Daroon: 50%.

The three cofounders build an MVP based on their idea by spending the major part of their capital *(The term 'capital' is usually referred to both equity capital and any other forms of funds. The meaning is perceived based on the context).* They are meeting potential customers for validation of their value proposition. They realise that further fund will be necessary within a couple of months for making progress and that ₹20 lakh may help them to complete the validation process. So, they approach one of their relatives (Uncle Faroon) for this sum, who agrees to invest it for 15% of the company [this means that uncle Faroon estimates the post-money value at [₹20 lakh/ 15% = ₹20 lakh/0.15 =] ₹133.33 lakh). What will be the percentage holding of all the four persons after the investment if they accept the offer/deal?

As per terms of the funding, Uncle Faroon must have 15% of equity post his investment.

The remaining 85% (100% - 15%) of equity is to be distributed among the cofounders on pro rata basis, i.e. in proportion to their existing holding. So, the remaining 85% of the holding is distributed among the 3 cofounders as under:

Aroon's share out of the remaining 85% of the share = his present holding of 20% X 85% = 17.00%

Baroon's share = his present holding of 30% X 85% = 25.50%

Daroon's share = his present holding of 50% X 85% = 42.50%

Uncle Faroon's share = 15.00% (as per terms of the investment)

Total = 100%

To clear any residual doubt, let's move one more step forward. Suppose the venture now has a validated product with complete Proof-of-Concept (POC) and, to put in place the required infrastructure to begin manufacturing, avails ₹100.0 lakh from an angel investor say, Haroon, for 20% of the company. What are the new holdings of various stakeholders in the company now?

Haroon's share = 20.00% by agreement.

The remaining 80% is distributed among the other four shareholders on pro-rata basis based on their latest shareholding.

Uncle Faroon's share = 15% X 80% = 12.00%

Aroon's share = 17% X 80% = 13.60%

Baroon's share = 25.50% X 80% = 20.40%

Daroon's share = 42.50% X 80% = 34.00%

At what valuation Haroon has invested ₹100 lakh?

Haroon's 20% is equal to ₹100 lakh. Therefore, 100% of the company = ₹100 lakh / 0.20 = ₹500 lakh, which is the post-money value of the company.

The value of the shares of the cofounders: Aroon (13.6% of ₹500 lakh): ₹68 lakh; Baroon (20.4% of ₹500 lakh): ₹102 lakh; Daroon (34% of ₹500 lakh): ₹170 lakh

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It may be observed that the holdings of the cofounders are declining in every round of funding [However, note also that the value of their reduced percentage holding has been increasing at every round of fund-raising]. This is based on the assumption that no new shares are allotted to the founders while creating new shares for the investors. The founders have two options while offering shares to new investors:

i. Create as many new shares as may be required to provide the desired percentage holding to new investors (20% in the case of angel as above).
ii. Take away shares from existing shareholders and allot them to new investors (appropriate number to ensure % holding). This is normally not practiced.

Cofounders may allot shares to themselves at any time at prevailing valuation (valuation per share).

At any point of time, the company may allot new shares to the founders in exchange for new investment in the company with specific consent from other investors. Creation of any new shares changes the percentage holding of all existing shareholders.

On the flip side, it is to be noted that the value of founders' holding usually increases though the percentage holdings decline. To understand it better, let us revisit the above story from the beginning:

The decision on the percentage holding that Uncle Faroon must have in exchange for his investment of ₹20 lakh depends on the current valuation of the company. When he agrees to bring in ₹ 20 lakh in exchange for 15% of the company, he necessarily values the company at 20/0.15 = 133.33 lakh post investment (Since his 15% of the company is valued ₹20 lakh). So, what are the value of the holdings of the cofounders at this stage?

Uncle Faroon's share is valued = ₹20 lakh (At face value. It is the determinant)

Aroon's share is valued = ₹133.33 X 17.00% = ₹ 22.66 lakh Baroon's share = ₹133.33 X 25.50% = ₹ 34.00 lakh

Daroon's share = ₹133.33 X 42.50% = ₹ 56.67 lakh

Haroon invests ₹100.00 lakh for 20% of the company, which means that he values the company at ₹100/20% = 100/0.20 = ₹500.00 lakh. This is known as post money valuation, i.e. value of the company after the money of the investors has been received by the company. Let's see the value of all the shareholders.

Haroon's share is valued at 20% of 500.00 = ₹100.00 lakh (this is the amount he has invested based on valuation done by him)

Faroon's share = 12.00% of ₹500.00 lakh = ₹ 60.00 lakh

Aaroon's share = 13.60% of ₹500.00 lakh = ₹ 68.00 lakh

Baroon’s share = 20.40% of ₹500.00 lakh = ₹ 102.00 lakh

Faroon’s share = 34.00% of ₹500.00 lakh = ₹ 170.00 lakh

Notice that the values of all the investors are on the rise in subsequent rounds of investment as new investors value the company higher. The opposite will happen if the valuation is lowered during any round of investment.

Table 1: Funding rounds, approximate quantum of fund, corresponding events

Funding round	Pre-Seed	Series - A	Series - B	Series - C
Stage Fucus	Proof of concept/ Prototype	Revenue growth	Growth	Large scale expansions
Common elements of growth	Hiring	Development operations, branding, marketing	Hiring, market expansion, buying businesses	Acquiring business, international market
Valuation (approx.)	5 M	25 M	60 M	➢ 60 M
Quantum of investment	Within one million dollars	Up to 10 million dollars	>10 & <$50 M	In the range of 50 million dollars