INVESTTECH

Democratization of Startup Financing

by Elena Mesropyan · July 12, 2018

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Over 11,000 FinTech startups are operating around the world across 15+ segments, with payments and lending startups consistently being among the most funded and represented. In the past decade, average deal sizes have grown significantly for startups in late-stage rounds, while seed-stage companies possibly lost their former appeal to an increasingly risk-averse VC community (and institutional investors).

It's never been easier to set up a business – all software necessary to set up essential functions is on the market today (Stripe Atlas, Holvi, Quickbooks, etc.). Given the team has critical human functions covered, mere financial survival is the persistently problematic part, whether a startup has a great proposition, or not.

In 2010, the average sums offered were $6.84 million for seed-stage companies, $20.31 million for early-stage VC rounds, and $26.64 million for VC rounds. In 2017, the average figures plummeted to $3 million for seed-stage companies but grew to $41 million for early-stage VC rounds and $1.566 billion for large-stage VC rounds.

Between 2010 and 2017, the average funding for seed-stage companies dropped by more than half (57%), as investors became wary of high-risk financial bets. Meanwhile, in the same period, the average funding for late-stage VC rounds went from $26.64 million to $1.566 billion.

MEDICI RESEARCH	2010		2017	
	TOTAL FUNDING	AVG.	TOTAL FUNDING	AVG.
Seed	205.3M	6.84M	851M	3M
Early-stage VC rounds	316.33M	20.31M	7.137B	41M
VC rounds	156M	20.31M	6.9B	1.566B

As for the total funding for various stages, in 2010, the total funding for seed-stage FinTech companies was at $205.3 million, for early-stage companies at $316.33 million, and at $156 million for late-stage companies. In 2017, only one of those still counts in millions, and you can guess which one. The total funding for seed-stage companies in 2017 reached $851 million, while the total funding of early-stage and late-stage companies hit $7.137 billion and $6.9 billion respectively.

With 9 out of 10 startups failing, the one that becomes a hit has to be not just incrementally better than the competition but offer a 10X better experience. To become that one startup out of ten, a startup requires significant resource investments – time, talent (all of which comes down to money) – to dive deep into understanding the market, performing research, building the product, testing, etc. None of that is possible without funding.

Eric Kryski, the Co-founder of Bidali and Founder & CEO of Bullish Ventures, explains it quite well:

> "Startups should not be looked at as some get-rich-quick scheme! Most fail miserably. Furthermore, nearly all of the successful ones that you have heard of were grinding for 2–3 years before you even knew about them. Even if you happen to be part of the minority that succeeds, you will most likely be running your business for 7 years before you see a large return. There is a lot more to the startup dream when you actually crunch the numbers."

Meanwhile, today, venture funding is concentrated at the later stages of financing, while the angel/seed deal value share has plummeted. The productivity of aggressive funds allocation is yet to be fully understood for all stages, but for entrepreneurs who are just starting out their challenging and turbulent journey, the outlook is not optimistic.

Startups operate in a highly imbalanced environment in terms of access to funds. For the longest time, VC funding (along with institutional investors) has been the most important source of fuel for an adequate runway. Founders step from round to round, changing the ownership structure, and not much is heard about those not being able to secure funding past the bootstrapped, FFF (fools, friends, family) stage. By Series A, the survival rate of US startups generally gets to about 40%, to ~25% by Series B, and by Series D it drops to about 5%.

With around 60% of companies that raise pre-Series A funding failing to make it to Series A or beyond, the approach to securing a financial lifeline was bound to change. And even though consumer markets are not stretched enough to give the opportunity for sustainable adoption for the ever-growing number of startups, financing opportunities are increasingly democratizing to allow for a broader audience to participate in startup funding.

Two significant changes are happening in the world of startup financing today:

1. Diminishing barriers to entry into the world of high-risk, high-reward investing for different types of investors (unaccredited).
2. Expansion of financing types/options and new financing models for startups to remain operational on early stages.

Both contribute to a general trend – the democratization of financing in the startup world.

In a step towards balancing the environment for startups to have more options, in May 2016, *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers came into effect in the US*, outlining the financial conditions under which individual investors can participate in Regulation Crowdfunding offerings. The act was introduced in 2012 by Obama but was approved and implemented in 2016 by the SEC.

The previous capital raising options had limited private companies to raising money only from accredited investors – historically the

raise from anyone up to $50 million under

p to $1 million under Regulation CF. These

n up investing to 240+ million Americans who previously could not invest.

Title IV Reg A+ (allows startups and later-stage, pre-IPO companies to use equity crowdfunding platforms like Crowdfunder, SeedInvest, and others to raise up to $50 million from both accredited and non-accredited investors) is broken up into two tiers: Tier 1 & Tier 2. Tier 1 allows companies to raise up to $20 million while Tier 2 allows up to $50 million.

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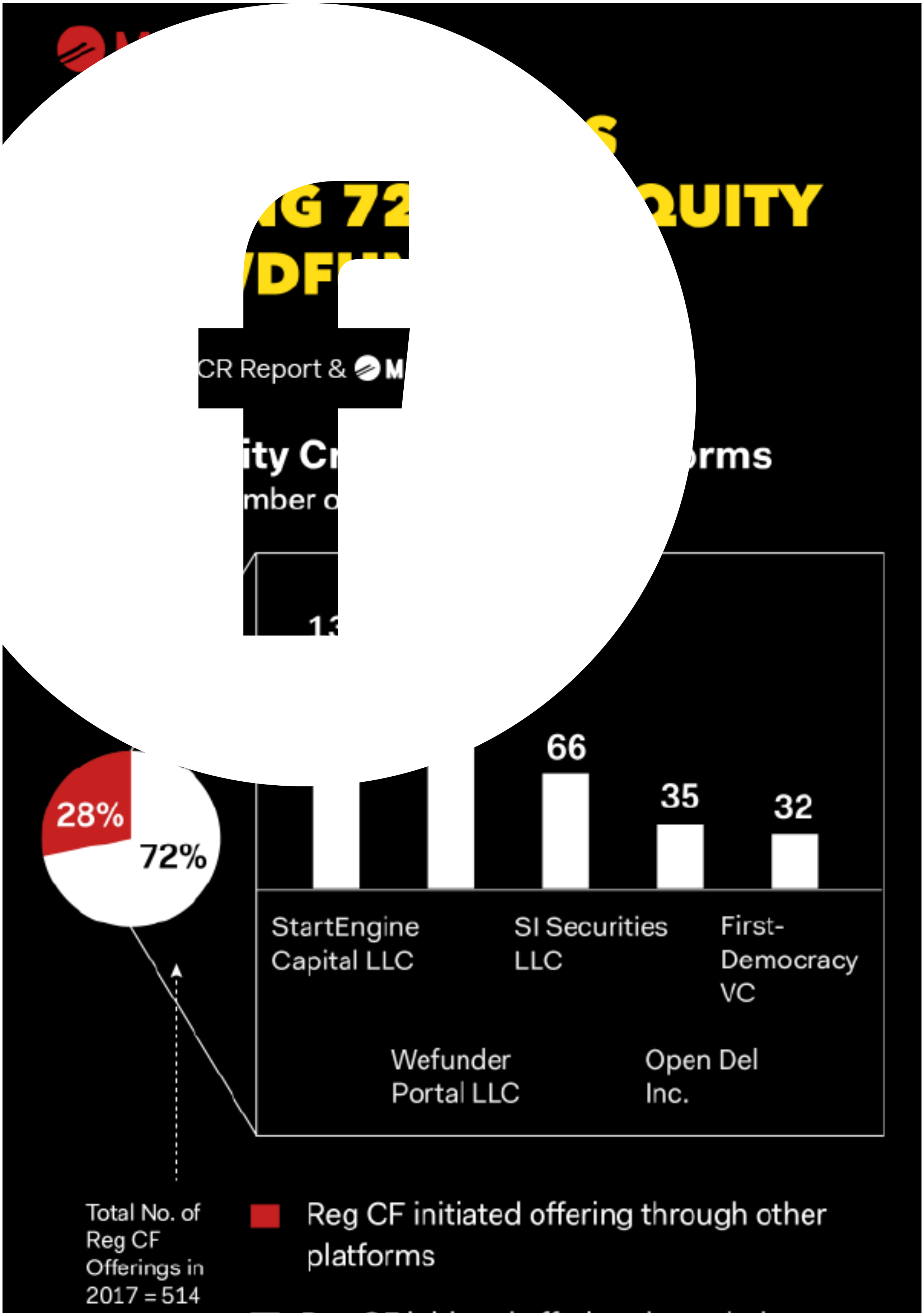
In 2017, 12% of equity crowdfunding platforms already drove 72% of Reg CF offerings in the US.

In the US financial services market, regulations such as Reg A+ and Reg CF have opened up new avenues for startups to raise financing from a large number of unaccredited investors along with accredited investors. Among the 636 companies that filed forms to conduct new offerings under Reg A+ or Reg CF, 80% of them (514) filed for Reg CF. In addition, the number of unique offerings for Reg CF increased by 267% in 2017 compared to 2016.


66
35
32
28%
72%
StartEngine Capital LLC
SI Securities LLC
First-Democracy VC
Wefunder Portal LLC
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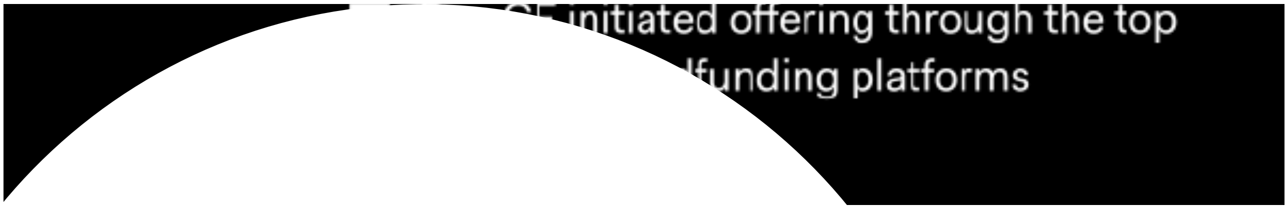
Total No. of Reg CF Offerings in 2017 = 514
Reg CF initiated offering through other platforms



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Offerings in 2 CI Research

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- -free grant
- Small or credit
- Incubators/accelerators
- Angel investors
- Venture capital
- Commitment to a major customer
- P2P lending
- Rewards-based crowdfunding
- B2B lending

- Equity-based crowdfunding
- Community shares and microfinance
- Donation-based crowdfunding
- Invoice trading
- Debt-based securities
- Equipment finance
- Merchant cash advance (MCA)
- Working capital lending

Each comes with drawbacks (for many, the interest rate is the most significant one).

If not mediated by industry experts, the types of funding sources involving a large number of unaccredited investors, for example, lead to startups missing out on valuable guidance and mentorship. Unaccredited investors, which today can participate in funding rounds, are not necessarily the best judges of a potential the business has. Money raised from unaccredited investors through equity crowdfunding platforms do not come with an educated assessment of the viability of the business model, or the plan, or the product by the crowd. Effectively, those choices bring nothing to the table except for the initial capital investment.

While angel investors and venture capital firms will ask founders to give up some portion of their control in some form, those options have been advantageous for at least the opportunity to expand valuable connections and buy-in some experts. When notable VCs come on board, they come with their network and the chance to jump through mistakes that others in that network can help with.

> As Mitchell Lee, Co-founder of Penny, said about the choice of raising the first milling with a VC, "In short, by raising venture capital, you're strapping yourself to a rocket, whether or not it goes up."
>
> "On the other hand, venture capital can be potent. We offer a consumer mobile app in an inherently un-viral vertical: personal finance. Venture capital would give us the resources we need to grow Penny in a hyper-competitive space." – Mitchell Lee, Penny

Andreessen Horowitz has a more general rule to a choice made by so many founders:

> "The most important thing to focus on here is finding investors that are appropriate for the stage of the company: e.g., an early-stage company should focus on early-stage investors. And if the startup is still in "company building mode," then focus on targeting investors that are company builders. You can always move onto later-stage investors as the company matures, but it's hard to go back to an early-stage investor after bringing in a later-stage investor."

With any loan from an institution, the drawbacks have been stable over the years – a lot of documentation, the necessity to invest time & resources in finding the best deal, and a risk to lose all assets to the institution in case of failure. Strict qualifying guidelines and high interest can also be prohibitive for bootstrapped entrepreneurs. While obtaining an online loan could be easier, the interest rates and/or fees remain high (some options reaching 40-80% APR).

Given the indisputable advantages having accredited investors on board brings, startups seem to have found a creative way to slow down the dilution (YC evaluates giving up as little as 10% of the company in a seed round as being an excellent deal, but most rounds will require up to 20% dilution, and founders should try to avoid more than 25%) before hitting the big game of later-rounds financing.

According to *Fortune,* seed rounds used to be a discrete event, but several forces changed that. On the early-stage side, innovations such as convertible debt, SAFE (Simple Agreement for Future Equity), AngelList, crowdfunding, and lean startup methodology enabled founders to diversify and stagger their funding sources. On the late-stage side, VCs have become increasingly risk-averse, preferring to pile massive amounts of money into safe bets. Most startups can't become safe bets after one seed round.

> "The new norm is a rolling seed process with three phases: pre-seed, seed, and post-seed. In pre-seed, startups raise up to $500,000, usually from friends & family, the founders, and

> crowdfunding sources. Seed encompasses the next $1 million to $2 million of money raised and includes an institutional investor such as a First Round Capital, Floodgate, or True Ventures. Now that startups essentially need to hit growth-stage milestones to raise a Series A, many founders need post-seed financing. These rounds tend to be around $3 million and bring the cumulative money in the company to around $5 million." – ***Here's How the Smartest Startup Founders Raise Funds***, Paul Martino, *Fortune*

The expansion of options for startups to get monetary infusion for growth and development does not necessarily translate into the quality of startups that survive longer. In fact, the creativity in obtaining funds and continuing operations through options not involving institutions, investors, VCs, or even angel investors – all have a significant drawback for all parties (entrepreneurial community, investors, and the consumer market). The ease of raising funds without having to onboard accredited investors and without having to loosen the founder's grip may translate into longer stages of misguidedness over the overall viability of the business. Unaccredited investors may end up enabling a slow failure, instead of a fast one where the team can move on, pivot, and evolve.

On the other hand, it's not uncommon for startups to be mistakenly passed over, only to prove to be an outstanding success in the future. The democratization of financing, while will undoubtedly fuel a lot more failures for longer times, is also a chance for truly innovative ideas to survive, benefiting both consumers and the industry.

For a deeper dive into the way equity crowdfunding enables individual investors to invest in a previously inaccessible asset class, democratizing financial access for more entrepreneurs (founders, as well as those looking to support local business ecosystems), read the latest insider brief called *"Water Water Everywhere, Not a Drop to Drink: Crowdfunding"* **by Amit Goel in** MEDICI Inner Circle**.**

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Elena is a research professional with a background in social sciences and extensive experience in consumer behavior studies and marketing analytics. She is passionate about technologies enabling financial inclusion for underprivileged and vulnerable groups of the population around the world.

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