stone& CHALK

Together we ideate. innovate. impact.

Capital Raising Guide for Startups

with thanks to our partners

AirTree birchal EthikaGroup FIREMARK VENTURES Jelix VENTURES lighter CAPITAL 1/ ONE VENTURES

r&. reinventure Right Click CAPITAL SeedSpace Venture Capital Square Peg Folklore

Stone & Chalk's Capital Raising Guide for Startups

Stone & Chalk exists to identify, nurture, connect and propel those who are seeking to solve the world's most pressing business and social challenges. In this sense our founders, partners, investors and mentors are **shaping the future, together**. Founded in fintech in 2015, Stone & Chalk is a not-for-profit organisation with a proven track record in developing successful growth and support frameworks for emerging tech sectors. We bring together founders, investors, industry and government stakeholders, and mentors into one powerful community which drives growth, advocacy, and commercialisation.

As startups grow, gain recognition, and commercialise, capital raising becomes a critical component of success. The funding landscape is constantly changing and investment options are diversifying. Venture capital (VC) still dominates startup funding, but other methods like crowdfunding are gaining traction. Deciding what will work for your startup will depend on a balance between your business objectives and vision, your financial needs, and external and market pressures.

The last few years have demonstrated the kind of volatility we can't exactly plan for, but for which we can and should prepare. We might not have expected 2020 to kick off with a global pandemic, but risk assessment and strategic mitigation are tools to not just avert big economic crises, but to build resilience and a better, more responsive startup – whatever the next challenge.

The impact of COVID-19 is ongoing and multi-faceted, and a collective effort is necessary for us to deal with the continued impacts. And there will be another side. In fact, right now, while many might face problems, there are also opportunities. Strong startups will survive. Businesses that were already vulnerable might not.

VC investors are ultimately driven by what's next, so despite COVID-19 and the subsequent slow-down, they're playing a big part in the recovery by looking to the companies of tomorrow. As Tempus Partners' Alister Coleman says "we understand that there is a high degree of economic uncertainty, but we believe in the catalytic power of technology and we are investing for the next decade and beyond, not just the next few months...great ideas and great founders do not stop in down times, they thrive."

Angel investors are investing, albeit at a slowed rate and with smaller cheques – all the more reason to get your pitch in shape and get in early. Expectations are high, competition is fierce, and you may need to approach double the number of investors to get results. But persist.

Right now, leadership counts. Empathy counts. Cash and contingency is crucial. The health of your staff and balance sheet has never mattered more. Address the short-term now, but don't forget to look long. Investors still want to know what your long-term plan is and how you'll be part of the solution.

Revisit risk and model worst case scenarios. Extend your runway to two years by tightening the belt where you can, making (if sometimes difficult) decisions quickly. Focus on your core proposition, refine and revise your product, and consider service opportunities that might arise. Investors are attracted to optimism and action. So how will you adapt?

Most importantly, stay connected. There has never been a more important time for new ventures to be part of a community where you can exchange ideas, learn from each other, and turn to high calibre mentors for advice. Get involved in our events and engage with the ecosystem.

Good luck and get ready to raise.

About Stone & Chalk

Stone & Chalk is the home for emerging tech innovation, where together we ideate. innovate. impact.

Whether you're a startup or a scaleup, at Stone & Chalk, you'll be fully supported to build and commercialise your ideas.

$1B+ Capital raised by residents and aulmni since joining stone & Chalk

230+
Startups and scaleups are making success happen

1,100+
Legendary residents call Stone & Chalk home

35
Corporate and Government partners collaborating with Stone & Chalk innovators

150+
Startups exporting to Asia, North America & Europe

147
Startups have graduated and become Alumni

11
Locations and 4 Innovation Hubs

Contents

Funding stages 5
- Pre-seed 5
- Seed 5
- Series A 6
- Series B 6
- Beyond B 6

Capital 8
- Bootstrapping 9
- Equity-based fundraising 10
- Family and friends 11
- Angel investment 11
- Venture Capital 12
- Corporate Venture Capital 13
- Venture Capital compared 14
- What do VCs look for? 15
- Debt-based fundraising 16
- Venture debt 17
- Convertible notes 17
- Simple agreement for future equity 18
- Revenue-based funding 18
- Crowdfunding 18
- Equity crowdfunding 19
- Investor-led crowdfunding 20
- Initial Public Offer 21

Issuing equity 22
- Term sheet 23
- Shareholders agreement 23
- Share subscription agreement 24
- Intellectual property assignment agreement 24
- Types of shares 26

Valuations 28
- How do I value my start-up? 29
- Valuation methodology 30

Get ready 34
- Stone & Chalk has developed a best practice 12-page slide outline which includes 36

Australian government initiatives 37
- Early stage innovation company (ESIC) 38
- Early stage venture capital limited partnership (ESVCLP) 38

Online resources 39
- Glossary 40
- Seed and post-seed funding 40
- Series A funding and beyond 40
- Other funding sources 40

Discalimer: this is a general guide only, written for an Australian audience. All dollar amounts are in AUD and provided as examples only. It does not constitute and should not be relied upon as professional, financial or legal advice. While every effort has been made to ensure the information in this guide is correct at the time of publication, Stone & Chalk takes no responsibility or liability (including, without limitation, for any direct or indirect or consequential costs, loss or damage or loss of profits) arising from anything done or not done by any party in reliance, whether wholly or partially, on any of the information contained herein. Any party that relies on the information contained in this publication does so at its own risk.

Funding stages

When and why you raise capital will be unique to your startup. You may be looking to stay liquid while you further work on your business model, you might need funds to create or take a minimum viable product (MVP) to market, or you might be ready to rapidly scale: ready for not just the money, but the experience, knowledge and contacts that can come with investment. Whichever it is, it helps to have an understanding of the common stages in startup funding.

Pre-seed

Pre-seed is the earliest stage of equity funding, when founders are still working independently or with a small team, and are yet to develop a prototype or proof-of-concept. Pre-seed funding often comes from family and friends, occasionally from an incubator or accelerator program or perhaps an angel investor.

Typical Raise:
up to
$150K

Seed

As a startup works through the problem solving phase and identifies potential market fit for their proposed product, seed capital might be sought to fund further development. Seed funding can come from angel investors or VC funds focused on early-stage investments. While determined by the team, traction, value proposition and commercial model, a seed round should raise roughly 12–18 months of operating runway. Seed funding is a key milestone for startups, but also the last stage for many, as those that don't gain traction before their seed money runs out will most likely fold or pivot.

Typical Raise:
$150K – $1M

Funding stages

Series A

Series A funding rounds are undertaken after a startup has obtained some product traction and user base, and has demonstrated potential for exponential growth through revenue, KPIs, or other metrics. The money raised in this round often comes from angel investors or VC funds and can be used to scale internationally, improve and optimise product, add to operational capability, and increase customer acquisition.

Typical Raise:

$1M – $5M

Series B

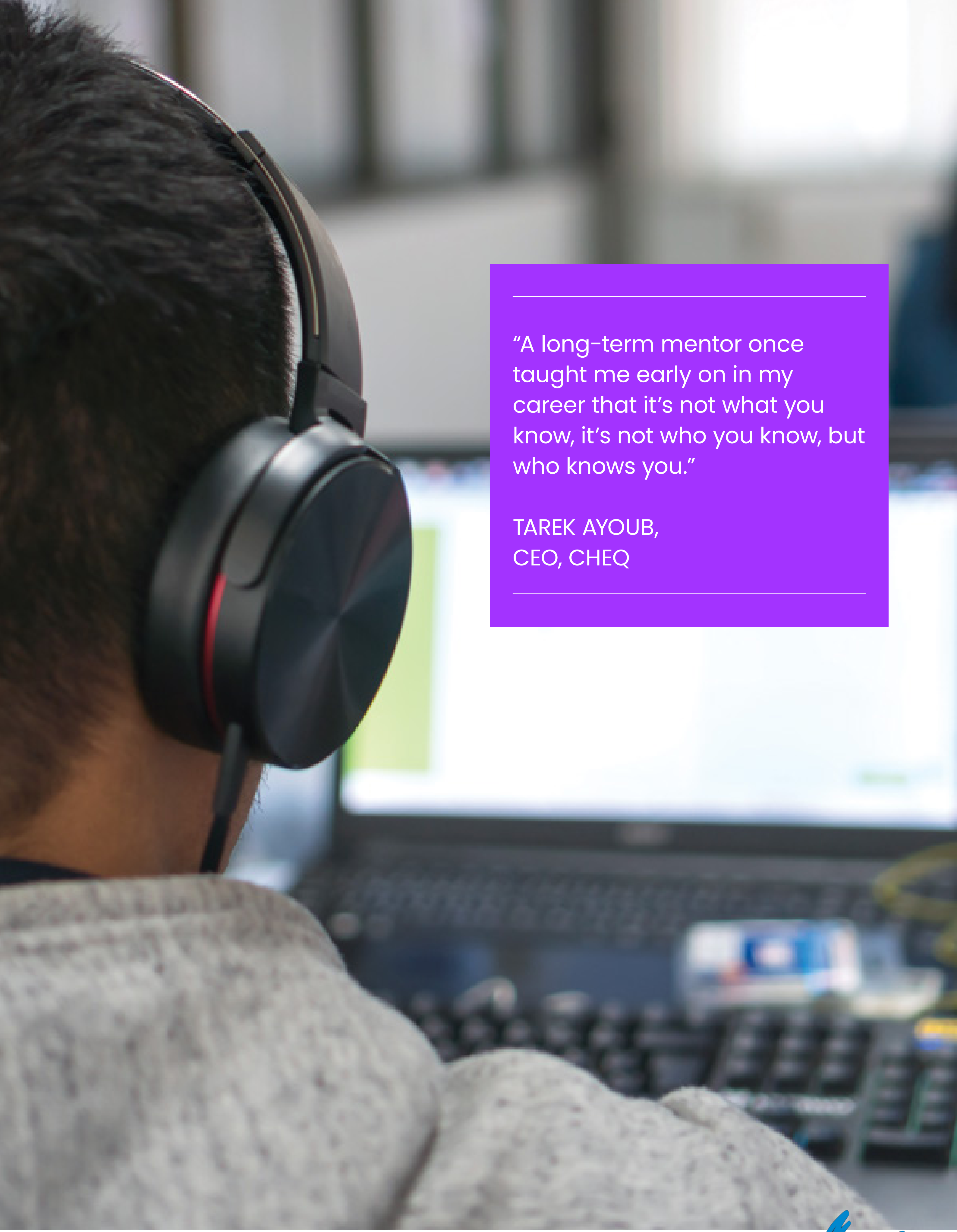
Series B funding rounds focus on scaling the startup. Capital is used to increase market share, grow the team and continue expansion. Series B funding often comes from VC funds and often from the same investors who led the previous round. It may also attract investments from later-stage VC funds.

Typical Raise:

$5M – $20M

Beyond B

Further funding rounds are designed to continue scaling the company, whether by developing new products, making acquisitions, increasing market share, expanding internationally, or preparing the company for exit. Funding rounds Beyond B generally come from large VC funds, private equity firms, hedge funds and investment funds.



"A long-term mentor once taught me early on in my career that it's not what you know, it's not who you know, but who knows you."

TAREK AYOUB,
CEO, CHEQ

Capital

Money.

How to get it.

Where to get it.

Who to get it from.

Bootstrapping

Startups that 'bootstrap' start lean and grow without the help of external capital. Bootstrapping relies on a founder's personal finances and the reinvestment of revenue back into business operations. Common in the early stages for most startups, some choose this option ongoing as founders retain 100% ownership and control, and can focus on rapid idea generation and building the business without the pressure of meeting the milestones and demands of investors.

However, without external capital, startups can't scale as quickly which might jeopardise their market position. In the innovation space, the 'first in' can leverage a bigger market share before competitors enter the market. It can also be difficult to grow, develop, iterate and expand unless the founder is independently able to fund marketing and acquisition activities.

Advantages

- Ability to execute quickly
- Develop a lean mindset
- Easy to pivot
- Maintain central ownership
- Founder able to spend more time on business rather than fundraising activities

Disadvantages

- Lack of external support
- Fewer opportunities for mentorship
- Limited access to networks
- Personal financial risk
- May limit ability to drive exponential growth

32%
of founders have not raised external funding

64%
of founders use personal finances to fund their business

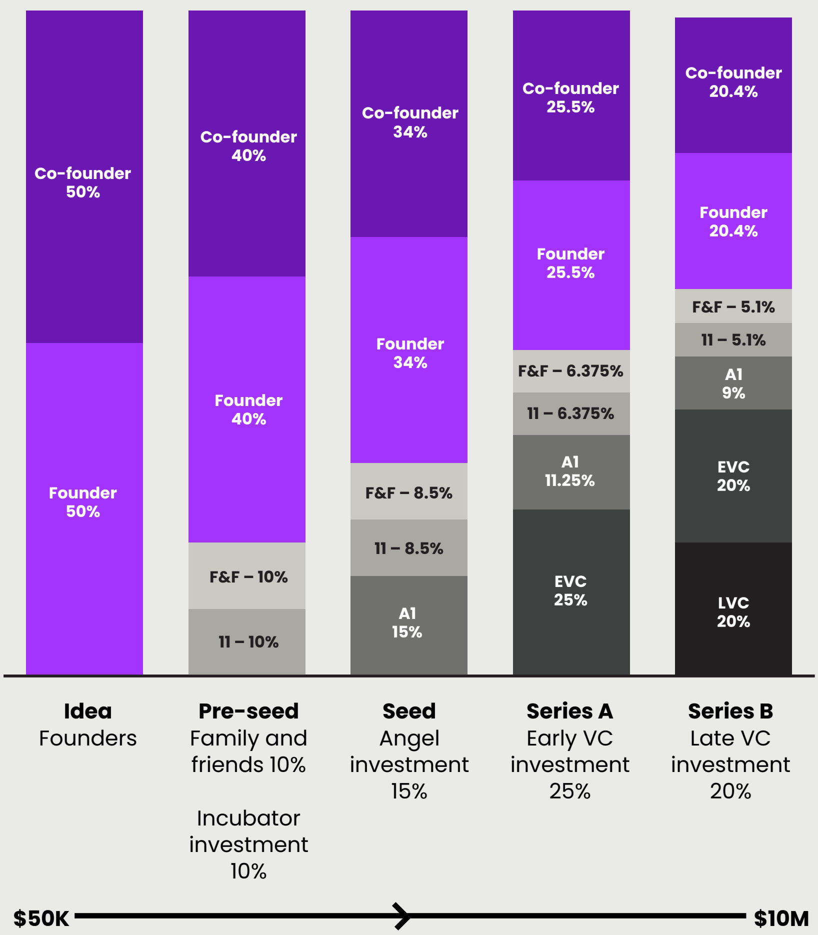
2018 Startup Muster Survey

Equity-based fundraising

When startups raise equity funding, they issue new shares to investors in exchange for capital injections. Negotiation in an equity round centres on the company's valuation and the rights and entitlements of the investor. Valuation determines how many shares the investor will receive in exchange for the capital invested and therefore the investor's percentage shareholding after the raise.

A simple example equity investment equation for startups

If all investors stay in and gain equity on investment, as external investment goes up the founders' share goes down (diluting ownership and sometimes control). But as the valuation of the company will increase (with any luck) over time, ultimately the value of your stake will also increase.



E.g. If your share as a founder goes down from 50% to 20.4% but the valuation increases from $50K to $10M, your financial stake goes up from $25K to $2.04M

Family and friends

Friends and family can be an important source of early, seed-stage capital to help get an idea off the ground. They're a good, fast source of funds as they don't necessarily require the formality of due diligence involved in commercial loans or investments. The associated risk gives the category its moniker, the 3Fs, with 'fools' added to 'family and friends' to indicate the potentially foolish nature of early investments. All parties need to be aware of the risks so that should your great idea fail, your relationships aren't ruined. It's important founders still apply a formal approach to confirm expectations and accountabilities. Before seeking funding, founders should know what kind of deal they want – whether equity or debt, what amount, interest rate or return – and it should be clearly included in your business plan. Startups should provide family and friend investors with at least a professional business plan as well as a SWOT (strengths, weaknesses, opportunities and threats) analysis. Holding multiple meetings to explain the business proposition and negotiating terms gives potential investors time to think it over. We recommend following formal protocol and using clearly defined term sheets and investor agreements.

Angel investment

Angel investors provide capital to startups in exchange for an equity stake during seed funding rounds. Angel investors might be professional investors, business executives, or high net worth individuals looking for investments with a possibility for a high rate of return. They might be a successful entrepreneur with skills and experience in the same sector or field as your startup. As a result, in addition to financial investment, angel investors can offer intellectual and network capital, providing startups with expertise, mentorship, and growth opportunities.

Angel investors fill the gap between small-scale 3F funding and VC funding. They're more willing to take risks than institutional investors and provide capital for early stage startups. However, they may require higher equity stakes in return, which represents ownership dilution for founders. Issuing convertible notes and SAFEs (simple agreement for future equity) is also becoming increasingly popular for angel investment.

As individual, unregulated operators, angel investors can be hard to find, unlike VC funds which are openly advertised and easy to research online. However as Angels are less restricted, they can write cheques quickly and without lengthy compliance and investment committee protocols.

Angel investors sometimes form a syndicate to share due diligence and risk across their investments. Syndicates allow individuals to pool funds for smaller investments and share skills and subject matter expertise between their member base. Sometimes called investor-led crowdfunding, there's more on this in the crowdfunding section.

Typical Raise:

$25K – $100K

for 5–15% equity

Venture Capital

Typically the first institutional investment in a startup comes from a VC fund. VC funds manage investments from their investors, called limited partners (LPs). A VC fund makes investment decisions for its LPs, most aiming to make a 3x return.

The focus of a VC fund may be specific to an industry, lifecycle stage, or location. For example, a VC fund might only invest in Australian fintech startups, or fintech scale-ups for international expansion. It's therefore important to research the VC's investment focus to ensure it aligns with your pitch.

The best way to approach a VC fund is through a warm introduction by someone engaged with the startup ecosystem. VC funds like to build relationships with startups well before they're looking to raise. Therefore it's usually recommended that you begin approaching VCs about 12 months before you anticipate actually needing money. This can be as simple as an email with a summary of the problem you're solving and a promise to stay in touch. This allows VC funds to interrogate the growth potential and veracity of the startup over time, and better assess its chances of success.

Corporate Venture Capital

While most venture capital comes from an institutional venture capital firm making investments on behalf of individuals and groups invested in the fund as limited partners, a substantial amount of venture capital in Australia comes from corporate venture capital funds.

CVCs can provide startups with funding along with the opportunity to gain strategic leverage from an established industry player.

CVCs can either be set up internally drawing investment capital directly from the balance sheet, or as a fund managed by an independent manager. CVCs often look for synergistic investment benefits for the corporation they represent. CVCs invest throughout the venture cycle, although some funds have a specific preferred stage range. By investing in startups, CVCs benefit from fresh market insights, disruptive technologies and emerging products and services.

Founded in 2011, **Telstra Ventures** was the earliest of the current crop of venture funds, both corporate and institutional. Australia's big banks began investing in corporate venture early in this current cycle with **Reinventure** and **IAG Firemark Ventures** kicking off in 2014, **NAB Ventures** at the end of 2015, and ANZi in 2018.

Venture Capital compared

It's worth noting that not all funds fall neatly into this table, it's simply to provide a general overview.

Differences	Institutional VCs	Independent CVCs	Balance Sheet CVCs
Examples	Carthona Capital, Rampersand, Right Click, Tempus Partners, AirTree, SquarePeg	Reinventure, Telstra Ventures	NAB Ventures, ANZi, Macquarie Direct Investment
Objectives	Prioritise a high financial return	Prioritise a high financial return but look for some strategic relevance to corporation	Balance financial returns and strategic objectives of the corporation
Strategic leverage	Offer expertise in building companies and driving financial results	Combine company building expertise with industry knowledge and access to corporate assets, distribution etc	Offer in-depth industry knowledge and access to existing customer base
Follow-on investment	Typically reserve capital for follow-ons into each investment over the life of a fund	Typically reserve capital for follow-ons into each investment over the life of a fund	Can be subject to their balance sheet and the strategic direction of the company; changes in economic conditions or leadership may jeopardise future commitments
Exit options	Prioritise strong financial return on exit whether through an IPO or trade sale, liquidating their sale within a specified time frame, potentially via a secondary market if need be	Prioritise strong financial return. Seek to engage the corporation as a potential acquirer where relevant but always as part of a contested sale process	Prioritise investment as an acquisition target, an OEM (original equipment manufacturer) partner, a channel for additional product sales, or product integration
Source of capital	Third-party limited partners	Committed fund from the corporation often alongside a commitment from the manager and sometimes third party funders	Often funded by the company's balance sheet alone

What do VCs look for?

Market	Is there a market need for the product? Is there an acute problem to be solved with evidence of its existence? Is the problem acute, recurring, recent and emotional? Is it a big enough problem to build a global business around? What is the size of the market and growth potential? Is it large enough to create a '10x business' and deliver high returns?
Product	How is the product different? Is the company solving a problem in a unique way? Can it defend against competitors entering the space? Does the company have IP its competitors don't have? Is the product resistant to economic cycles, protected from obsolescence and mitigated against downside risk?
Capabilities	What are the skills and experiences of the founding team? Have you run a startup previously? What experience and insight do you have in entrepreneurship and the founder journey? Is it an A team or B team? Investors generally prefer an A team with a B idea rather than a B team with an A idea because an A team will iterate and find the A idea.
Growth	What are the growth metrics? Monthly revenue, user acquisition, units sold, downloads, referrals?
Financials	What is the profit margin/cash-burn rate? What is the annual recurring revenue? Do you have reference investments?
Exit	Chances of cash-out? Are there opportunities for exiting? Who are the potential buyouts?

Since 2017 Australian startups have surpassed an annual $1 billion in VC raised.

Debt-based fundraising

Whereas equity-based fundraising exchanges capital for a stake in the company with which an investor recoups investment, debt-based fundraising follows a classic borrow/return model, where money lent now is repaid to the lender later at a predetermined rate.

Most debt funders require an established cash flow or the use of fixed property as collateral. **Valiant Finance** offers a simple tool for qualifying your ability to access debt across more than 80 lenders in the market. Note though, the majority of startups, especially those in the early stages, will not have the option to raise a debt round because they aren't attractive borrowers.

Raising debt at Series A stage is however becoming increasingly common in Australia through specialist venture debt funds which look for startups with consistent and clear cash flows and a clear investment plan which can lead to profitability in the medium term.

Advantages

- Existing shareholders' stake isn't diluted and ownership is maintained
- It can be cheaper to raise debt than to raise bridging funding between major rounds
- Debt raises generally move faster than equity
- Business debt can create more tax deductions

Disadvantages

- Repayment can be a huge burden on a startup yet to generate profit
- Too much debt can also impact profitability and valuation, impacting future equity raises
- Debt raises require the company to be a lot more confident with regards to future cash-flow

When to raise debt

A company's creditworthiness is the highest immediately after raising a new round of equity. If startups are raising a combination of equity and debt, they should consider engaging with a lender once they have a few equity term sheet agreements so that the debt financing syncs with equity fundraising. However, if raising debt is the sole financing option, the best time to engage with lenders is during periods of sufficient liquidity and operating runway to increase bargaining leverage.

Venture debt

Venture debt is a flexible form of financing for high growth businesses. Cheaper and less dilutive than equity finance, venture debt can be used in conjunction with an equity financing round or between rounds to extend runway to reach your next business milestone. Unlike a loan from a bank, venture debt, like that offered by **One Ventures**, **Partners for Growth** and **Investec**, provides credit that's covenant light, flexible with limited restrictions and is well suited to technology businesses. The lender may be able to reduce admin going forward and offer further assistance through taking a board observer role.

Venture debt providers would however take security over company assets and rank senior to equity, and as such be paid out first at a liquidation event.

Venture debt represents good value to existing shareholders as their stake won't be diluted, improving their overall returns. All in all, with venture debt, you're up for the cost of the loan, which includes interest during the life of the loan, plus a small piece of the exit proceeds via a warrant for having helped you on your way.

Convertible notes

Convertible notes are a hybrid of equity and debt, usually used during seed rounds or as bridge financing between rounds. Startups borrow money from investors and the loan will either be repaid, or it converts to equity in the startup on a predetermined trigger event, eg. raising a priced round or a liquidity event.

Convertible notes delay the need to value the startup, so a deal can be done quickly and with lower legal fees. It's a particularly attractive source of funding for seed-stage startups with little upon which to base valuations. Some convertible notes come with a valuation cap (a maximum price at which it will convert into equity). They can also be useful for raising a bridging round.

As it can be difficult for investors to determine whether the terms of a note are fair or the risks are worth the return, and wary of foregoing shareholder rights (like voting rights, control rights, pro-rata rights, and liquidation preferences), a startup might offer higher discounts for converting loans to equity, eg. around 20–25%.

Example: if in the next round the company raises money at $1.00 per share, and you had previously invested $100,000 on a convertible note with a 20% conversion discount, you would receive shares at $0.80/share, instead of $1.00. That would mean receiving 125,000 shares, rather than the 100,000 shares your $100,000 would buy if you had waited to participate in the round directly.

Be aware though that if future equity rounds are not completed, a convertible note remains debt and requires redemption, which can increase the risk of bankruptcy.

Simple agreement for future equity

The Simple Agreement for Future Equity (SAFE) is a relatively new way of raising capital. Introduced by Y Combinator in the United States, SAFE is becoming increasingly popular in other countries including Australia. SAFE is similar to a convertible note without the debt component. An investor makes a cash payment (not a loan) to a company and in return receives a contractual right to receive equity when a predetermined trigger event occurs – usually a priced round and a liquidation event. The number of shares investors receive is linked to the up-front cash payment and the share price of the priced round or liquidation event.

SAFEs don't come with a fixed term, eliminating the need to keep track of individual financing deadlines, and as there's no interest payable, the complexity of converting interest into equity doesn't apply. Unlike other debt instruments, they don't have to be repaid and aren't regulated, making them an attractive option for startups.

Revenue-based funding

Ecommerce businesses or startups with a high level of recurring revenue could look at revenue-based financing from new entrants into the Australian market like **Lighter Capital** and **Clearbanc**. Both US- based, Lighter Capital has soft-launched locally with **Innovation Bay's** Ian Gardiner as business development manager.

Using data-driven risk assessment tools, a revenue-based model plugs directly into your revenue stream to map funding to your real-time revenue. This way, projections are used to structure the loan, and in the case of Lighter Capital, a percentage of cash receipts directly contribute to repayment to mitigate risk.

Crowdfunding

Crowdfunding is capital raised through the presale of products, experiences and/ or donations of money from the public. The most common way this occurs is online, through social media and other crowdfunding platforms. Crowdfunding campaigns have two key components: raising capital and promoting your product or service. There are four models of crowdfunding: reward-based, equity- based, charitable, and debt-based.

Reward-based crowdfunding platforms are a popular way for startups to pitch an early-stage idea and to validate a new product or service. Examples of reward-based crowdfunding platforms include **Pozible**, **ReadyFundGo**, **Kickstarter** and **Indiegogo**.

Equity crowdfunding

Equity Crowdfunding is a newly regulated way for everyday investors, people new to investing, or mums and dads and millennials, to invest in startups and early stage companies. Unlike other models of crowdfunding, equity crowdfunding gives investors an equity stake in the company.

There are over 10 licensed equity crowdfunding platforms in Australia and each operates slightly differently so it's worth looking into which would be the best one for your company and comparing the fees on the raise amount. Examples of equity crowdfunding platforms include **Birchal**, **OnMarket**, **Equitise** and **VentureCrowd**.

Equity crowdfunding's main advantages over conventional equity-based investment lies in speed of acquisition and the value created from having a large community of advocates.

It has proven to be a viable option for all early stages of equity-based fundraising – pre-seed to series A. Investors get ordinary shares in the company as opposed to preferred shares typically issued to VC's or angel investors.

With public visibility for the capital raise, the ability to generate significant funding provides social proof and early validation for the product or service. Similarly, a failure to raise your required amount can impact future capital rounds as it may suggest insufficient interest.

Although this financing option is growing rapidly overseas, locally its adoption was held back due to regulatory restrictions so it's not mainstream just yet. Equity crowdfunding is open to companies with an annual takeover or gross assets of $25 million or less. The amount they can raise is also capped at $5 million annually. Retail investors (also known as Mum and Dad investors) are limited to investing $10k and there is no limit for wholesale and sophisticated investors.

One concern with equity crowdfunding is the impact of a large number of small investors on your share registry for future raises and handling requests for information.

Like all equity-based fundraising options, startups should try to avoid overvaluing the company and raising more than necessary. It's important to hit milestones to avoid down rounds, where later investors pay less for the company's stocks than previous investors, indicating an initial over-valuation or bigger viability issues.

Investor-led crowdfunding

The investor-led model of crowdfunding is an attractive option as startups and founders do not incur fees. Instead, investors in a syndicate pay a fee on top of their initial investment so as not to impinge on limited early stage funds.

Conducting commercial due diligence and risk analysis of investment opportunities better protects investors. Increasing confidence in the investment in turn aids completed raise rounds. Founders may also benefit from investor expertise to further accelerate growth.

Examples include: **Jelix Ventures**, **Eleanor Ventures** and **Scale**.

Initial Public Offer

Going public' with an initial public offering (IPO), is a company's first sale of shares to the public at large. The Australian Securities Exchange (ASX) considers a capital raising range of $10-20 million to be a good entry-level raise.

Advantages

- Raise a large amount of capital from the open market for a company's current operations, refinancing, and expansion
- Create a market for the company's shares: creating liquidity in the shares
- Raise the profile of the company with media, customers, suppliers and investors
- Provide an exit-strategy for early investors
- Ability to raise capital efficiently and quickly post-listing, eg. via a placement (~2 days)

Disadvantages

- Dilution and some loss of control for owners
- Shareholders gain ability to form majority and remove a founder if unhappy with performance
- Increased regulations and corporate governance including reporting auditable accounting information on a regular basis and having a board of directors
- Total cost of going public eg. listing fee, underwriting, and prospectus preparations tends to be 5–9% of funds the company is looking to raise
- Risk of public failure to raise required funds if the public disagrees with IPO price, eg. WeWork's 2019 postponed IPO

Reverse takeover

A possibly risky and roundabout way to list, a reverse takeover can lower the barrier to ASX and public access. An RTO uses an existing company (a possibly defunct or sleeping listing) as a shell company. Eg. neobank **Douugh** recently staged a takeover of telco **Ziptel**, buying a majority of its shares to essentially rebrand and reinvent itself from the inside out (all while gaining access to public investment).

Requirements for listing on the ASX – Click here

IPO Process and listing on the ASX – Click here

Issuing **equity**

When you issue equity in return for a financial investment, you essentially hand over partial ownership of your startup to the investor. This ownership can be big and influential or relatively small and have minimal impact. But issuing equity is the start of the founders' dilution of ownership and control. So, you need to think carefully about why and how you'll issue equity and make sure you're aware of the terms and conditions that come with it.

Term sheet

A term sheet is an important document that outlines the specific terms and conditions of a raise between an investor and founder. The term sheet is often prepared by the VC or other investor and presented to a startup's founders. It's generally non-binding and details what the company is giving and receiving in return, it's like a blueprint of the relationship between the investor and the founder. Term sheets can vary depending on what type of funding round you are embarking on, how much is at stake and who's involved. Access templates to use as a guide from the **Australian Investment Council**.

What to consider

Round terms: how much is the investment and how big is the round

Valuation: the startup valuation both before and after the investment (pre- money and post-money)

Board seat: will the investor/fund gain a board seat

Voting rights: on incorporation amendments and board appointments

Employee share option plan (ESOP): what portion of the company is set aside for employee share options

Liquidation preferences: order of proceeds/distribution on liquidation

Anti-dilution rights: whether new shares can be released in future

Pro-rata and right of first refusal: what entitlements will existing shareholders have to invest in future rounds on a pro- rata basis or to purchase any shares sold to a third party at a price agreed to by the third party

Shareholders agreement

A shareholders agreement is a crucial record for founders to have in place from day one, which keeps track of investment and other ownership interests in your startup. So, once a new term sheet is agreed and signed, the next step is revisiting your existing shareholders agreement, drafting and negotiating the operative, binding, deal documents and updating the status of shareholders' stakes. A shareholders agreement sets out the relationship between the company's shareholders as well as the division of power between shareholders and directors. It covers matters such as issuing new shares, selling existing shares, how board and shareholder meetings should be conducted, how decisions should be made and how disputes should be resolved.

Share subscription agreement

A share subscription agreement formalises the terms of the investment with a specific investor. It details how many shares the startup is issuing, conditions the shares are subject to, the price for the shares and when the startup will issue those shares. It will also include warranties for the investor's benefit.

A share subscription agreement is necessary when an investor requests one, otherwise it's not in the company's interest to make the offer. Alternatively, a share subscription letter, a shorter document outlining key terms and conditions but not the company's warranty, may be suitable and the investor can conduct their own due diligence. Share letters are often used in seed/angel investment rounds.

If raising from a VC, it's more likely they will insist on having a share subscription agreement. Once parties have signed share subscription agreements, the investor and company will pass a resolution approving the issuance of shares, the investor will pay the subscription money, companies will issue share certificates and notify **ASIC** of its shareholdings.

Intellectual property assignment agreement

Intellectual property (IP) is critical to your startup's value. Founders may have personally owned their IP in the early stages. When assigning IP over, do so in the same company or legal structure in which your investor is investing. An IP assignment grants ownership in intellectual property from one person or company to another. It's common in employment agreements to ensure that intellectual property created by employees is owned by the company. They can also be used to assign pre-existing intellectual property to a new company.

Startup name:
Hyper Anna

Founded:
2016

Founder/Cofounder:
Natalie Ngyen/
Sam Zheng

Raised:
$17M+

Investors:
IAG, Seqoia, Reinventure, Airtree

Case study

While the investment pitch is generally the responsibility of co-founders, Hyper Anna's Financial Controller Connor Tam is quick to recognise the accumulated hard work from the whole team in building out the pitch and making the startup a fundraising success. Everyone from the sales team, customer retention, account management, product and finance all played their part, collating and contributing the results and unique attributes that heralded Hyper Anna's strengths and high-growth viability.

Choosing to bootstrap for eight months gave the team the time to identify their product's unique values and to focus on how to deliver that value to their customers. Without any experience in raising capital, they were also fastidious in their research and sought help from experienced advisors. They weren't concerned with being secretive about their idea, and were confident it was their execution and application of the idea that made the startup attractive to customers and consequently, investors.

Hyper Anna focussed their efforts on using different mediums to connect to different people and with their target audience in mind, and wanting the product to speak for itself, their resulting pitch was 70% product demo, 30% verbal and documentation. 'With an intuitive product' Connor says, 'we tend to let it speak for itself.'

Accepting that COVID-19 will impact the economy, but how and how much is unknown, Hyper Anna have used the time to reflect rather than compromise, gaining profound insight about how we can collectively and individually face a global situation like this. Connor concludes that 'this is a testing time for all teams and companies, but we believe that the future is a bright one.'

Types of shares

Generally, early investors like angels and friends and family invest in ordinary shares, whereas VCs usually invest in preferred shares with a 1x liquidation preference. But there are other terms founders should be familiar with, and wary of. Non-standard terms might include participating preferred shares, capped and convertible options. Always read the fine print and avoid overly-complicated agreements where possible.

Ordinary shares

As the most basic type of shares, ordinary shares tend to be issued to founders, early investors and employees. Ordinary shareholders have a share in the company, generally have voting rights, and can benefit from future company profits.

Preferred shares

Preferred shares provide additional rights to ordinary shares, giving preferred shareholders seniority and therefore a greater claim on a company's assets. Preferred shareholders have voting rights, and are paid dividends before ordinary shareholders. If they have liquidation preferences, they will be paid out first in the event of liquidation.

Liquidation preference

Liquidation preference dictates the order of payout in the event of liquidation. It determines who gets their money first and how much they get so it's important that founders understand any liquidation terms proposed and the risks and results if triggered. Liquidation preference is only relevant when a company is sold through a merger or acquisition, or when assets are sold during a bankruptcy process. In general, preferred shareholders get their money back first, before anything is paid to ordinary shareholders. When a company goes through an IPO, preferred shares are converted into ordinary shares, and the division becomes irrelevant.

Liquidation preference multiple

The multiple determines how much money should be paid to the investor with preferred shares before ordinary shareholders. For example, a multiple of two means that the investors get their investment back, times 2, before the remaining proceeds are divided among the ordinary shareholders. A lower multiple is better for founders and other early investors.

Participating preference shares

Participating shares entitle investors to a specified payment upon liquidation as well as a share in any remaining liquidation proceeds on an as-converted to ordinary shares (pro-rata) basis. Non-participating preference shares is preferred for founders, with a conversion ratio of 1-to-1.

Convertible

Convertible preference shares are fixed- income securities that guarantee pre-defined interest on investments. An investor can convert these securities into shares after a certain point in time, which the investor will do once this option becomes financially viable based on the conversion rate.

Capped

If dealing with participating preferred shares, a founder should ensure a cap is added to the term sheet. If there's a cap, then participating preferred shareholders will stop sharing in the proceeds once they reach the capped amount. They start participating again once the common shareholders have received the same amount per share as the preferred shareholders.

VC terms usually include a 1x liquidation preference

Eg. if the VC invests $500k for 50% at a $1m valuation, but the company subsequently sells at only $600k the VC will get $500k and the founder (and other ordinary shareholders) the remaining $100k. But if the company sells for $10m the VC will get $5m and the founder $5m.

Seniority structures

Standard seniority executes payouts for the latest round of investments first and first round investments last. This is the most used seniority structure, since earlier stage investors often rely on later stage investors for the startup to survive.

Pari passu (equal footing) seniority provides all preferred shareholders with the same seniority, with proceeds divided pro-rata to their committed capital, not pro-rata to their stake in the business. Any decisions start with investors with the highest conversion point, as the outcome for one investor depends on the decisions of other investors to convert or exercise liquidation preference.

Pari passu is almost exclusively used for unicorns with prominent founders, as they attract significant funding options and later stage investors have no claim to demand seniority.

Valuations

Determining the value of your startup is a daunting task, but it’s an important step on the path to capital raising. The valuation will not only help determine how much you might subsequently raise, but how much the startup is subsequently worth. This post-money value indicates an investors’ potential return and ultimately helps establish a price on exit or share price in any future IPO.

How do I value my startup?

Unfortunately, there's no definitive answer. Many factors influence a startup's pre-money valuation. If a startup is generating sustainable revenues, the method used for valuation will look a lot like the established models (revenue and earnings multiples) used to value mature companies. Ideally the business can demonstrate increasing revenue streams, reducing the financial risk of failure and increasing the prospect of a big exit.

Without years of financial data to refer to, startups and prospective investors have to rely on creative and subjective determinants. It might be easiest to tackle the issue of valuation by investigating what an investor looks for when valuing an early stage startup.

Factors to consider in valuation:

How 'hot' is the industry/sector?

How much investment money is in the market?

What's the status of the supply and demand of capital?

What's the valuation of a comparable startup in the same/similar sector What's the comparative size of similar exits locally and internationally?

Can current competition with other startups and investors help create FOMO (fear of missing out)?

How long is the remaining business operating runway and how desperate is the founder for money?

What kind of traction is there? Is the customer base growing and revenue stream increasing?

How good is the team, is it an A team?

Do they have significant industry knowledge?

Does the company have unique IP? Eg. proprietary tech, algorithm, etc.

Factors that are not usually considered in valuation:

How much the founder thinks the business will be worth in the future

How much time, money or effort the founder(s) have put into the business already

'Interest' from potential customers, without signed purchase orders or written commitment

Valuation methodology

Valuing an early stage startup is particularly difficult, but investors have subject matter expertise that provides a mental picture of the average size and price for a particular stage/round relative to other startups and deals in the marketplace at any given time. They have their finger on the pulse of the industry, but might broadly apply the following thinking to sense check a valuation.

1. Stage and Berkus approach

This approach values startups by their stage of development and growth. The further down the pathway, the lower the startup's risk and therefore the higher its value.

For example:

Early stage business concept:
$250k–$500k

Lean experiments and MVP built:
$500k–$1m

Product launched/revenue stream/management team in place:
$1.5m–$2m

2. Raise restricted approach

This approach works on the basic assumption that the amount of money startups need to raise and the equity they're prepared to give up determines the valuation range. Going outside of this range starts to impact the commercials of the investment.

For example:

A startup wants to raise $500k to give it a 12-month runway to grow and achieve its set milestones and gain traction. Any amount lower than $500k would only constrict the business, increasing the risk of failure and loss of investment. Giving investors 50% would leave founders with too little equity and incentive for hard work. A standard equity sale ranges between 12–25% per round. With the raise amount set at $500k, the post-money valuation would range from $4.16m (at 12%) and $2m (at 25%). Typically ventures raise sufficient funds for 9-12 months runway in their seed round, 12-18 months in their Series A and 18-24 months in Series B and beyond.

3. Incubator's approach

Some incubators have navigated the challenge of valuing early stage companies by simply applying a standard valuation of $1m or $1.5m for all companies in their program, with their investment of $50k to $150k representing a 5% to 10% stake.

4. VC approach

The venture capital method calculates value based on a process whereby investors, say, looking to exit within 3 to 7 years, first estimate an expected exit price for the investment. Then, calculating back to the post-money valuation today, they take into account the time and the risk made by the investors to determine an expected return on investment.

Case study

Startup name:
CHEQ

Founded:
2019

Founder/Cofounder:
Tarek Ayoub (CEO) and Dean Mao (CTO)

Raised:
$2M+

Investors:
VFS Group

For over five years, Tarek read up on founders and fundraising, and the accumulated knowledge has definitely helped. As has the amazing group of mentors who have guided him in his career. Which is to say, his wasn't an overnight success, but a methodical, evidence-backed approach.

Founders wear many hats and as neither had raised capital previously, Tarek took on the task of pitch preparation and investor relations while Dean concentrated on the technology strategy and ensuring investors understood how the technology would be developed. Without a product, the idea had to be solid, the plan to launch and scale watertight, and they had to focus on the experience and ability of the founding team to execute it.

The complexity of the product and licenses required just to develop the app meant Tarek had to dive in early and raise capital at idea stage, so their plan was vital to win buy-in. They approached potential vendors to exercise their theory and test the plan before approaching investors. Starting with connections, they approached the market, always asking for referrals to additional VCs and brokers.

Within a month they had a fund to lead the first round, closing a $2m terms sheet pre-product. As Tarek points out – this might sound fast, but it stemmed from relationships he'd nurtured over years and years. 'I made a list of everyone in my life I thought might be interested and ranked them. Warm or cold I began outreach systematically, tracking every email open, following up with phone calls.'

When it came to pitching and promoting, Tarek didn't hold back on details. He's a firm believer in the power of a founder. In fact, he says, 'overprotecting an idea may come across as a lack of confidence or understanding of what it really takes to build a company.' So be outspoken and, in addition to your idea, trust that it's your know-how and passion for it, that makes the package the attraction.

After all, VCs are investing in founders first and then the idea. 'Failing to understand this concept is part of the reason why most founders fail to raise money. They concentrate on the idea more than making investors understand that no one else can pull this off except them.' But be smart about it, IP he did hold close to his chest was the nitty gritty of their algorithm – what they shared instead that spoke volumes, was what the algorithm aims to achieve.

Case Study (continued)

His pitch was 50% verbal, 50% documented. Tarek memorised the lot so he could keep the conversation flowing. Now, at public events he has a pitch that's 70% verbal and 30% documentation. His pitch 'tells a story' describing the problem and presenting data to demonstrate the size of the problem. Using a real-life scenario to bring it to life, he then demonstrates how the product solves the problem – how it works, and how innovative it is compared with other products.

A Management Consultant for a big global firm in a past life, Tarek was schooled in the importance of reputation and relationship building, and it was his ongoing commitment to the task that drew mentors to him and fostered generosity. Being genuine and likeable has definitely helped as the mentors and investors you meet ultimately join you on a long-term journey of ups and downs.

Tarek accepts timing is critical. The success of giants such as AfterPay and Zip in developing an alternative credit product helped influence the market's bullish appetite at the time. Then of course came COVID-19, and instead of pursuing a new round geared to exponential growth, the team decided to raise a small bridging round to go into survival mode for 18 months.

COVID-19 is definitely testing the fine line between increasing exposure and decreasing risk, but the team remains flexible, compromises where they can, and strives each day to add value for users and investors. The next 12 months will see $10m lent to users, improvements to product and much more of that new phenomenon we're all growing accustomed to – virtual beer o'clock.

Get ready

It's crucial that startups can articulate their value proposition concisely and convincingly. Startups should have solid, succinct presentations at the ready to entice investors. There are two main versions every founder needs: a pitch deck and an investor deck.

Pitch deck

What you use when pitching on stage or to an audience

Supports your in-person presentation

Very visual, tells a story, often slides have just an image

Focuses on problem, unique value proposition, and differentiation from competition

Introduces the market opportunity, team, and future plans

Tells your story and vision in simple human terms

Slides contain only very basic info, with images and graphics for support

For an audience with no prior information

Investor deck

What you send (usually via email) ahead of time to get the meeting

Can be read by itself, with no additional context or explaining needed

Introduces the problem and covers the key value proposition

Focuses on the market opportunity and unfair advantage of the startup

Focuses on the team and their relevant qualifications

Discusses go-to-market strategy in detail

Talks about your vision in mostly business terms

For an audience with some (or more) prior information

Stone & Chalk has developed a best practice 12-page slide outline which includes:

1. **Cover/Intro**
   Name of your startup and your purpose in a sentence
2. **Key insight story**
   How you discovered the need/problem and why you're serving/solving it
3. **Concise problem statement**
   What is it and how are existing players approaching/neglecting it (highlight the resulting limitations)
4. **Relevant market opportunity**
   The market, target customer, target market size
5. **Competitors**
   Demonstrate the depth and extent of your homework in the competitor space and where your company is positioned among it all
6. **Your solution/USP**
   What is your unique selling proposition and why is your product a game changer?
7. **Competitive advantage**
   What have you got that will be hard to replicate?
8. **Your team**
   Expertise, shared history, resilience and startup experience
9. **Traction**
   Timeline, milestones and customers
10. **Business model**
    Financials and revenue streams
11. **Financial status**
    Historical and projections linked to product roadmap
12. **Raise**
    How much are you looking to raise and for how much equity?

Australian government initiatives

Since 2015, the Australian federal government has made a commitment to drive innovation, foster the commercialisation of research, and promote a culture of entrepreneurship with tax incentives available for eligible investors of early stage ventures.

Early stage innovation company (ESIC)

If a startup is ESIC qualified, it allows their investors to access tax incentives. The easiest method for companies to ascertain whether they qualify as an ESIC company is to carry out a self-assessment through the early stage test and the 100 point test.

Take the **100 point test**

ESIC investment incentive:
20% carry-forward tax offset (capped at $200,000 per investor/year) and a 10-year exemption on capital gains tax for shares held in an ESIC company for at least 12 months (provided the shares don't constitute more than 30% interest in the startup)

Early stage venture capital limited partnership (ESVCLP)

The ESVCLP program aims to stimulate the early stage VC sector in Australia by: helping fund managers attract pooled capital so they can raise new VC funds of between $10m and $200m to invest in innovative early stage businesses; offering tax benefits to fund managers and investors; connecting investors with early stage businesses, and helping Australian businesses grow by receiving financial support and guidance from expert advisers.

Fund managers can apply to Innovation and Science Australia to register a partnership as an ESVCLP

Take the full list **of ESVCLPS here**

Online **resources**

Hall and Wilcox offer Stone & Chalk resident startups a free consultation and **Allens Linklaters** offers the A-Suite of legal documents to get your company up and running without a significant outlay of time or money.

Airtree Ventures' open source templates include seed stage, term sheet, seed financing documents and employee option plan documents. And their list of active VC funds can be found **here**.

The **Australian Investment Council** has free term sheet and shareholders agreement templates you can use as a guide.

Pankaj Singh's list of 300+ global VC funds and their investment verticals.

Glossary

- **Basic definitions** of common terms used in business and a more detailed list from the **ASX**

Seed and post-seed funding

- **Follow the Seed:** B2B, B2C
- **Rampersand:** tech startups
- **SeedSpace:** fintech (including marketplace), B2B, B2C
- **Tempus Partners:** industry agnostic, globally scalable software and advance technology startups

Series A funding and beyond

- **Airtree:** AI, fintech, deeptech, SaaS, marketplaces
- **Artesian:** software and hardware startups in agrifood, clean energy and medtech
- **Grok Ventures:** fast growing technology-enabled businesses
- **IAG Firemark Ventures:** everything insurance-related, AI, machine- learning, cybersecurity
- **NAB Ventures:** fintech (payments, wealth management, PFM, lending), proptech, data analytics and AI, cybersecurity
- **Reinventure:** fintech, data, AI, SaaS, agtech, edtech, insuretech
- **Right Click Capital:** analytics, communications, cyber, cryptocurrency, etc. Also do seed and pre-seed
- **SquarePeg:** broad thesis with multiple fintech investments

Other funding sources

- **Birchal:** equity crowdfunding
- **One Ventures:** venture debt
- **Lighter Capital:** revenue-based funding
- **Jelix:** investor-led crowdfunding

stone& CHALK

Together we ideate. innovate. impact.

stoneandchalk.com.au/founders