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Process and Leverage in Fundraising

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11-14 minutes

In any negotiation, leverage is the pressure that you can bring to bear on the other party to achieve your goals. While leverage is never the only thing that matters, it is a powerful and generally misunderstood tool.[1] It is critical to understand when and where to use leverage while fundraising. However, I've noticed that many founders – and most first-time founders – don't think systematically about leverage.

Though you can generate leverage from a number of different sources, fundraising leverage generally comes down to effectively using an investor's fear of missing out on an outlier company. Because most venture returns are driven by a tiny number of companies, investors know that they need to invest in those companies in order to make money.[2]

The trick, then, is convincing investors that your company will be one of those outliers. The way you do this varies slightly by stage, but always comes down to a mix of traction, team, vision, market opportunity, and product. Founders who combine these elements in a way that makes their upcoming success appear inevitable generally have more leverage while raising money.[3]

I used to think that founders were limited to these five elements in raising money, but in running our Series A program, we uncovered a way to materially influence the leverage a founder has in any round: process. Running a tight process while fundraising is a deceptively complex task. On the surface, it seems very simple, but without conscious focus, founders invariably screw it up.

Process is important because it gives founders the best opportunity to create a market for startups that favors the founders in the most important aspect of raising money: getting the right investor. While a "good" market can also influence price, the quality of the investor is the most important target of leverage.

The difference between a market that favors founders vs one that favors investors is not the difference between an open market and a closed one. The difference is based on who has more information about – and control over – the process of the raise.

Serial fundraising tilts markets to investors

Early stage startups usually operate in markets that favor investors. This is because the founders of those startups usually pitch investors serially – one by one as they convince those investors to meet and hear a pitch. Each time the founder walks into a meeting with an investor, the investor has full control of whether or not to make an investment decision.

As a founder meets with each new investor, chances are that some information about the company has reached the incremental investor before the meeting. This is because the network of investors is relatively small and often collaborative. Each investor that meets the company therefore has an information advantage, and knows that either a) this company has been passed on before or b) this company is gaining momentum.

The investor in this dynamic has total ability to set the process and terms. If the deal is slow, then there's no reason to move quickly. If the deal is moving faster, then the investor gets to enter a bid with significant knowledge of terms and capacity. This is a great place for the investor to be.

Parallel fundraising tilts markets to founders

Founders who can reverse the information advantage create markets that favor them. When founders are able to create the same starting point for a large number of investors, the investors are forced to operate in parallel. This means that any piece of information investors get has less time to spread through the network, which forces investors to make decisions on their own.

What's more, investors are not able to get a sense of whether or not the market is moving quickly, so they need to make decisions under the assumption that it is. If they don't operate under this assumption, then they'll lose their chance to invest in what they've come to believe is an outlier because someone else will grab it.

On a purely psychological level, this kind of opacity creates a competitive dynamic in a group of people – investors – who are extremely competitive. This is a significant advantage for founders.

YC took this idea one step further by batching companies. Because our companies fundraise together they're willing to share information about where the market is at any given time, as well as pass on useful information about specific investors. When I first experienced this in the days leading up to Demo Day, I thought about it as a union for startups where we were able to create a sort of collective bargaining position. It was and still is powerful.

Investors are incentivized to stop founder tilted markets from forming. As a result, founders have significant leverage both during the market's existence, and just before it is created. Founders can create this type of dynamic whenever they raise.[4]

Series A Process

I'd been conditioned, by Demo Day, to believe that founder tilted markets required an actual Demo Day. In building our Series A Program and watching dozens of As happen outside of Demo Day, I learned that it isn't the day itself or the absolute number of investors that's most important. What's most important is the process in which Demo Day forces founders and investors to participate. Founders can create this same dynamic whenever they raise by making sure that the number of investors getting first time access to the company at the same time is greater than 1.

When thinking through a Series A, I advise founders to select a group of 15-20 investors who they think will, one day, be the right partners for the life of the company. Figuring out who these investors are is more art than science. However, there are techniques which can help. Founders should talk to other founders in their industry to find out who is helpful and who simply writes checks. They should spend time reading the posts that investors write – this will tell them what the investors are interested in and what they like to talk about.[5]

At some point well in advance of the actual raise, founders should start meeting with a subset of those investors. Founders should work through that subset until they find the group with whom they actually want to work. Founders need to impress and engage the investors through these meetings without sharing so much that the investor can fully evaluate a decision.[6] Part of this is done by clearly communicating a timeline for when fundraising will actually start.

While these pre-fundraising meetings are valuable, founders shouldn't confuse them with actual fundraising. I've had founders tell me that the best way to raise an A is to pretend that they're not raising at all, and just have lots of social conversations with investors. This is almost always a bad strategy. The founders who have the most success in raising clearly and actively decide when to raise and then communicate that decision to investors, advisors, and other founders.[7] These founders run well thought through processes in which they prepare their stories and decks, prepare diligence items, set up formal pitch meetings with the investors they liked most, and practice.

Founders who spend time figuring out who they want to work with before they start a formal process ensure that they have a market made up entirely of good investors. They've limited their risk of only receiving term sheets from investors they don't want to work with. At this point, founders have already started the process to tilt markets in their favor.

Founders continue to improve the tilt of the market by grouping meetings as tightly as possible by stage. First pitches should all happen within a one to two week period, partnership pitches in a different one to two week period. Ideally, this means that investors make their offers at the same time, without being able to collude or discover that others have passed.

There are two different common errors at this point – some founders let initial meetings drag out over the course of months, which moves the market back into the investor's favor. The other end is sometimes worse: founders create artificially tight deadlines for term sheets. Investors tend to react very badly to this latter case unless the momentum behind the company and deal are incredible.

Getting this sequencing right is tricky because investors who know more about the company – and know that a fundraising process is coming – will be heavily incentivized to try to move ahead of all the other investors. Founders have to manage this carefully. On the one hand, founders need to make sure that all of their introductory meetings happen in a tight timeframe so that all funds are moving at the same pace.

On the other hand, there are often inside investors who are good enough – and aggressive enough – to offer quality terms before a formal raise begins. Balancing this tension is different in every situation, and it's a good thing to discuss with someone with no interest in that round.[8] Often, these early offers are good enough to take without running the process.

Founders who do not take pre-emptive offers must push the process forward. Managing this tightly creates the exact same type of market that our founders see at demo day, if at slightly smaller scale. I've been amazed at the impact of arranging meetings in a week instead of letting them drag out over many. At the same time, running a sloppy process – one in which founders lose track of the schedule or make overly aggressive timing demands – can completely destroy a fundraise for a good company.

Work vs. Fundraising

A final word of caution: founders often become obsessed with the process of fundraising. This is usually a fatal mistake for their companies. It is much easier to spend time theorizing and optimizing about when and how to apply leverage to specific investors than it is to focus on the fundamentals of a company.

In nearly every fundraise I've seen, great companies barrel through and keep going, no matter how heavily they optimize. Bad companies twist themselves into knots, celebrate silly meetings, and then run out of money – no matter how much they raise.

Knowing when and how to fundraise is important, but it's only worth thinking about when founders need to raise. Any other time spent on it is time that should be spent writing code and talking to users.

Notes

1. I wrote some other thoughts on negotiating a few years ago: http://www.aaronkharris.com/guidelines-when-negotiating.↩

2. Paul's essay on the distribution of venture returns is excellent http://www.paulgraham.com/swan.html.↩

3. My partner Geoff has written about this extensively: https://blog.ycombinator.com/how-to-raise-a-seed-round/. While his essay is focused on seed rounds, the advice generally applies to all rounds.↩

4. While the rest of this post focuses specifically on the Series A process, all companies can use something similar for whatever round they are raising.↩

5. http://www.aaronkharris.com/utopia-bets-slash-apocalypse-bets.↩

6. There's more to be said about how best to conduct these meetings, but I'll cover that in another essay.↩

7. Deciding when you're actually ready to raise an A, or run any fundraise, is tricky. I'm working on a better framework for this decision.↩

8. This is a lot of what we do in YC's Series A Program.↩

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