Funding the Technology Startup (part 1)

... where and how to find the $$$

Seattle HMCEN
2009

Rule # 1

Most technology startups fail because they run out of money.

They run out of money because ...

1. They don't get to adequate revenues (sales) fast enough.
2. They take too long to develop their product (which compounds problem number 1, although problem number one can be caused by other problems as well.
3. They are unsuccessful at raising funds to get them through their development and initial sales periods.

Three types of companies with different funding requirements

- Bootstrap company
  - Requires little or no outside financing, perhaps $250,000 or so, often funded by founder, friends and family, or a small angel investor.
  - Management: Owner/founder Exit: Typically none
- Angel or small VC financed company
  - May require between $1 million to $5 million, often funded by angels or an angel group or small VC firm.
  - Management: Loose, competent Exit: Considering options
- The large-VC (or equivalent) financed company
  - Will require $5 million or more, possibly much more, typically from large VC firms or equivalent.
  - Management: Professional, hand-picked Exit: Clearly planned

1. The Bootstrap Company

Typically a relatively small company with a simpler technology that does not require a lot of development time and does not have to penetrate a large and expensive market. This is often a "lifestyle" company where owners and investors are content to accepts profits as returns. Either self-financed or financed with a small investment like $250,000.

These companies can grow in size and eventually develop interest as a company that can attract funding, complete with exit strategy (typically acquisition).

Mudd examples: WolfeTech, Dreamhost, I/O Software

2. The Angel or small-VC Funded Company

Yen Pham and wife, Link4

This type of company typically has a longer product development period and/or anticipates slow sales growth in early phases, with negative cashflow for an extended period of time. Consequently the company finds it necessary to raise, say, somewhere between $1 million and $5 million.

This company might try to rely upon angel (or angel group, like the Tech Coast Angels) funding or funding from a smaller VC firm (like California Technology Ventures) that specializes in smaller development deals.

This company ***must*** have an exit strategy.

3. The large-VC (or equivalent) Funded Company

This company is an ambitious, serious play, with a clear exit strategy (or exit options), extremely fast technology development and aggressive sales expansion plans. This company also requires a lot of money to realize these plans and is willing to share a significant equity position (perhaps majority) with a funder.

This company may require $5 million or more (sometimes much, much more) and will likely raise the funding in a series of funding rounds.

Potential sources of funding include the large VC firms, some private equity firms, or the equity investment arms of technology firms (like Intel Capital, who may be investing to acquire the technology).

4. The accelerator/incubator funded company

Company is typically a very early stage company that is perceived by investors as potentially a very fast play – all in over a summer. Most a/i funders will host the company for a summer (or a few months), provide expertise, contacts with a deep network, and other legal resources.

Y-Combinator currently offers $100,000 for 7% - 8% of a company with very simple term sheets. An Idealab (Pasadena) a/i is offering $50,000 for 10%.

You have to get to proof of concept very, very fast! This is not for you if you need time to prove your concept or develop your market.

Jonathan and Max, LayerbyLayer, Voodoo Manufacturing

What is an "exit strategy"?

Professional investors are unwilling to consider a startup as a candidate for their invested money unless they consider it highly likely that they will receive a very high return to their investment if the company succeeds, partly because they know there is a very high risk that the company will fail.

They are not interested in a company that promises to make high profits and pay them out as dividends. They will only be interested in a company that has an exit strategy, or exit options.

Generally, exit options consist of either (a) plans to go public in an IPO, or (b) positioning the company for a very profitable acquisition (buyout) by a larger company.

Only the most ambitious and well-funded startups are IPO candidates. Most Mudd companies become acquisition targets.

Teacher's summary: what they say they want

- Tremendous return on investment
- Hi-speed growth and quick exit
- The trilogy
  - Exciting and differentiated product(s)
  - Quality team
  - (Typically) evidence of revenues and sales
- IP protection if applicable
- Where they differ
  - What is an exciting product?

Terms you often see

- Pivot
- A product that "solves a major problem"
- Early mover advantage
  - Market share gobbler
  - First to market
- "Must have" product
- Unfair competitive advantage (often IP)
- Barriers to entry (IP)
- The next big thing