Beyond equity: the full range of startup financing instruments

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This startup financing series is a collaboration between Spendesk and CFOConnect. Join this leading finance community here.

As a founder coach and investor, I support European entrepreneurs on their journey from founder to CEO. Many founders are unaware of just how many financing instruments are at their disposal. So, together with CFO Connect, I rounded up a host of experts to clear the fog.

Typically when we think of startup financing, we think of equity or “venture” capital. A company raises its Series A or B round from a well-known fund, and hands over a stake in the business in return.

But **the financing landscape is much more diverse than it seems**.

In recent years, investors have found ways to make alternative funding available to growth and even early stage companies. Thanks to more accurate marketing attribution and decreasing transaction costs, we now get the opportunity to play with all the tools of the big boys!

In this series, we’ll explore some of the lesser-known (but often highly appealing) options available to companies. We’ll hear from founders who’ve employed these funding sources, and investors looking for promising companies to work with. I want to stress how important it is to get a feel for the hearts and minds behind the money. **Successful financing is not defined in technical terms, but by the working relationship with your investors**.

Let’s begin with an essential distinction. All of our financing instruments fall into one of these two general categories:

The technical side: equity & debt capital

As I wrote above, we tend to think of equity first when thinking about startup capital. Early-stage startups do tend to chase funding with equity. Here, your investors directly become co-owners of the business. For this reason, there's no limit to their upside - **if the company's valuation rises, their shares equally increase in value**.

Because of the fact that equity investors have unlimited upside, they have a vested interest in the valuation of the company. And therefore they'll likely do everything within their power to increase the valuation of the company. Which is why venture capitalists want to sit on boards, by the way. Raising equity means giving up some control. **It also means subscribing to a "go big or go home" mentality**.

Conversely, you raise debt capital when you have real assets in the business. Those assets can be used as collateral for the debt. For example, if a company uses asset-based financing and defaults on its payments, the lender will then own those assets. Like a mortgage for a business. This way, banks and other investors mitigate the risks involved.

Which is why **early stage startups are very rarely able to finance from debt investors**.

In case of default, debt investors will always be preferred over equity investors. If my company goes bankrupt today, the State will always look at debt investors first, and equity investors last.

This is also why debt investors are more conservative in their diligence process. Debt contracts are formulated to prevent the downside and keep capital safe.

Debt upside is limited. Which is why debt should always be the cheaper financing instrument compared to equity.

The human side: who is your dream investor?

In order to bring you a first-hand account of these tools, we've brought together a group of experts who have either invested or financed their companies with these instruments. Their stories detail the pros and cons of the following financing options. We hope to promote a differentiated view of the organisations, business models, and how the people behind the logos have decided on one instrument versus the other.

We'll learn the **typical use cases for each instrument, and how founders should evaluate their viability**. What are the costs? What are the benefits? Who is the target group, and are there any sensible alternatives?

We'll also learn more about the other side of the table. Why do investors offer these options? What's in it for them? What drives them? This is one of the reasons why we also feature investors in this series - you need to get a feeling for the human side of finance.

Overall, the goal is to lay out these different options to make sure that you, the reader, have the full funding picture in front of you.

And in this piece, I want to simply set the table with a few vital definitions:

Common types of funding for startups

Venture capital (equity)

Let’s start with the instrument most founders are already well aware of. Venture capital investors take a piece of a company (equity) in exchange for funds. For founders, **this is a highly expensive agreement, which reflects the level of risk the investors are taking**.

Investors offer funds (capital) typically for up to 10 years, with the understanding that when the company is sold or goes public, they’ll see a return of many times that initial investment. The return is realized by selling the shares during the exit.

Despite the prevalence of this approach in the tech and startup scenes, **only a small share of companies worldwide actually receive venture capital**. Investors want to see a strong product and a business model that’s likely to scale - hopefully quickly.

Venture debt (debt)

Venture debt is an interesting form of debt financing, usually best suited to companies who’ve already received equity-backed funding, but don’t have a long list of assets to use as collateral.

Unlike venture *capital***, venture debt is still just a loan**. If everything goes smoothly, you use this loan to spur growth over a relatively short period (12-48 months), and make regular payments along the way. Founders like that the loan doesn’t dilute their stake in the company, as do the other investors already on board.

But what makes it different from a traditional loan is that venture debt lenders take stock warrants to mitigate the risk while allowing them to charge lower rates. This is why **venture debt is usually reserved for companies that already show a clear product-market fit**, and have a smart growth strategy in place.

Asset-based financing (debt)

Asset-based financing works well for those companies with clear and valuable assets - as the name suggests. These assets are then used as collateral against a loan.

This functions much like a mortgage: if you fail to make repayments, the bank can take the assets. In practice, this funding instrument is **often used by companies with production facilities, or those in the sharing economy**.

Revenue-based financing (debt)

Revenue-based financing tied directly to marketing or advertising spend, **where the company can show a positive return on investment**.

So if you can show that every euro you invest in advertising brings back two in return, you’ll be able to borrow against this return. We’ll have a full article explaining this in detail, but it essentially works like this:

- The lender gives the full funding up-front, as a loan.
- The company makes monthly repayments. The amount repaid is a set percentage of monthly revenue.
- These payments continue until the loan has been repaid *plus interest*.
- After a certain period of time, if the loan hasn't been repaid via revenue, the outstanding amount is due.

So the nice part is, if you can bring in more revenue through marketing, you repay the loan faster and avoid interest. So **it incentivizes good performance**. On the other hand, if business is slow, you can wind up paying more than you bargained for.

Receivables financing or "factoring" (debt)

Factoring uses a similar principle to the asset-based approach above. In this case, **the "asset" in question are the outstanding invoices held by a company**.

If you're a supplier of goods or services and you need short term cash, you can essentially sell your accounts receivable to a third party. You'll have to sell them at a discount to do so, but you'll have access to immediate funds. And the bank or other third party will profit when the invoice is eventually paid.

This practice is very common and there are plenty of variables to consider. We'll explore these more fully in our article later, but for now we should differentiate factoring from a similar practice...

Supply chain financing (debt)

Also known as "reverse factoring," supply chain financing works similarly to factoring, but with some nuances. It usually involves a buyer, a supplier, and a third party which contributes cash in the short term. And crucially, it's usually initiated by the *buyer*.

Under this model, **the buyer is given more time to fulfill their payment to a particular supplier**. This gives them more working capital, which they might use to pay more urgent bills, or invest in timely campaigns.

To buy more time in this way, a third party (often a bank) pays the supplier's outstanding invoice immediately - sometimes ahead of schedule. So the supplier has its cash on or ahead of time. And when it's time for the buyer to pay, the money goes to either the third party or the supplier, depending on which holds the account at the time.

Note: supply chain financing isn't technically a debt or loan. The bank will obviously charge a fee for the service, but there aren't the same assets involved.

Inventory financing

On its face, inventory financing is very similar to asset-based financing. It also lets companies secure a loan to purchase goods (inventory), with those same goods acting as collateral. Of course, this **lets companies with little available cash buy the goods they need to sell up front**, and then pay back the loan once the goods are sold.

Since we'll have distinct articles on asset-based and inventory financing, those articles will set out the more precise differences between the two. But here's an example:

- A car dealership might use inventory financing to purchase its fleet. These cars will be sold eventually, and the dealership will make repayments with each sale.
- A car rental service might use asset-based finance to purchase its fleet. The fleet isn't *inventory* in the same sense, because these cars are to borrow, not sell. But the rental service can still use the cars as collateral against a loan, and will make repayments from rental fees.

We'll certainly go into more detail in the articles to come.

Traditional bank loans

Last but not least, we'll look at classic bank loans. Because even if the famous tech startups we all know went down the glamorous equity route, **the majority of small businesses still rely on bank loans to get off the ground**.

And remember, equity is the most expensive form of financing. So while it might get you on TechCrunch, a loan is the cheaper option once you qualify for it.

How to design a financing strategy for your business

As we've just seen, capital can come in the form of existing financial assets, or raised from debt or equity financing.

In other words, businesses will typically consider three types of business capital:

- **Working capital** - your current assets minus any liabilities.
- **Equity capital** - funds paid to the company by investors in exchange for stock or a share of the business.
- **Debt capital** - funds provided to the company, to be repaid with interest in the future.

We won't explore working capital optimization in detail in this series. But it's worth noting that for many businesses, simply optimizing working capital is the best way to fund growth. Free up money by reducing inefficiencies, and you'll have more to invest wherever it's needed.

When you design your financing strategy, begin with the question "who is my dream investor and how do I want to work with her?" You are setting yourself up in a pretty long-term business relationship. Make sure you are well-aligned with the other side of the table on a personal side as much as the terms.

But this whole series is about the faces behind financing instruments. We want to present a range of financing options for startups in different growth phases, industries, and with different business models. Most importantly, we want to share the stories behind the terms.

And when you're considering all of these options, there's one key fact to remember:

The price of financing always increases with the inherent risk.

In other words, if you need money to take bigger risks, you'll have to pay more to get it. Which leads to the obvious question: what will you spend the money on? Your job as founder or financial leader is to scrutinize the risk you're trying to finance, and choose the appropriate financing mechanism accordingly.

And there's a very basic scale by which you can just financing:

Debt is more risk averse and suited to later stage companies or safer assets, while equity is riskier and suited to early stage startups or projects.

If you have real collateral to offer, you're likely better off accepting debt. But if you have no collateral, the only thing left to give is a piece of the company.

One size doesn't fit all in startup financing

Despite what you've just read, there isn't any one obvious route to raise funds. As a venture capital investor myself, I regularly see companies seeking that big seed or Series A round, when they'd be far better off with a less dilutive, shorter term solution.

Not every company needs equity investors. And it's not as simple as young businesses versus older ones, or tech versus "brick and mortar." We'll see examples of fresh startups raising debt capital from day one, and others getting quick funds through revenue or venture debt without losing equity.

We'll also hear from investors using innovative funding strategies and finding ways to promote greener, more sustainable businesses in their growth phases.

The goal is to give you a full catalogue of options from which to shape your company's future.

Read more on startup financing

- How asset-based financing works for growing businesses
- What is venture debt? A complementary alternative to venture capital
- How revenue-based financing supports sustainable startup growth
- Supply chain financing: a smart solution for fast working capital
- Inventory financing for startups: how to grow with debt funding
- How startup business loans compare with venture capital

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