Funding New Venture

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SUMMARY # 19

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"*An entrepreneur without funding is a musician without an instrument.*" — Robert A. Rice Jr.

"*Nothing ever happens for dreamers and talkers; opportunity must be seized or created by sheer force of will and ambition*."
— Robert A. Rice, Jr.

Some definitions
Debt: is loan that is to be repaid with interest.
Equity shares: each equity share represents a part ownership in a venture and is issued in exchange for payment to it. The total ownership of any venture is represented by its equity capital divided into small value shares. The ownership rights are proportional to the number of equity shares held by an individual or company and it dictates the influence on decision making by the company. From a company perspective, there is no obligation of repayment of the equity share and no interest is to be paid. The shareholders received dividend whenever the management announces. It is also referred to as common stock.
Preference shares: Has features of both debt and equity. It is company share without voting right and it attracts compulsory dividend almost as interest except that the dividends are payable out of profit, else it gets accumulated.

Today's Topic: Understanding the Funding Mathematics

In the previous note, we have seen how percentage holdings of cofounders and investors change with a new round of investments. Let us understand the same in terms of the number of equity shares. The equity share capital represents the money invested in it by the owners of the company and the company allocates a number of shares to individual owners in proportion to the amounts of their investments. Each share has a par value, also known as face value, as decided by the founders. The face value may be ₹1 to any amount. The most popular face value is ₹10. This means that if one owner invests ₹1,00,000/- as equity in a business s/he would receive (1,00,000 ÷ 10 =) 10,000 shares, assuming that there is no share premium (Each share will have higher market value, in contrast to face value, depending on the value created by the venture and the difference between the market value and the face value is the share premium). Under a special case, the cofounders may allocate some shares to particular cofounders in exchange for their special contributions such as technologies, skills, or experience. However, the money for each share allocated to all the owners has to be investment by some cofounders. For simplicity, this note does not consider such cases.

When the three co-founders Aroon, Baroon, and Daroon, invest a total of ₹5.0 lakh as equity capital of face value of ₹10/- per share in a new venture, a total of 50,000 shares are allocated to them and their percentage holdings are as follows:

Cofounder	Amount invested	Number of shares	% holding
Aroon	₹1.0 lakh	10,000	10,000/50,000= 20%
Baroon	₹ 1.5 lakh	15,000	30
Daroon	₹ 2.5 lakh	25,000	50

It is important to understand that the value of a venture is held in its equity shares. At the outset, the value of the above enterprise is only ₹5.0 lakh i.e. the investment made by the shareholders. During the subsequent rounds of investments, shares are allocated based on percentage holding that an investor demand in exchange for their investments. Suppose, they make the first prototype, maybe the MVP, and an investor values that technology at ₹100 lakh, the value of the venture becomes ₹105.0 lakh (5.0 of equity + 100.0 for the product). This is the pre-money value. This value when added to the proposed investment becomes the post-money value. In the previous example, when Uncle Faroon makes an investment of ₹20 lakh for 15% of the company (it means 15% of the equity capital of the company), he makes a post-money valuation of (20÷0.15 =) ₹133.33 lakh which translates into a pre-money valuation of (133.33 – 20 =) ₹113.33 lakh.

How many shares does Uncle Faroon receive?

The total number of shares prior to the investment round was 50,000.
Post the investment, the co-founders are to jointly hold 85% (100 – 15% of Faroon)
This means that the 50,000 shares that the cofounders were holding will now be equivalent to 85% of the new equity shares of the venture after allotment of shares to Haroon.
Thus, 50,000 shares = 85% of the total shares. Therefore, total number of shares = 50,000 ÷ 0.85 = 58,825 (rounded off).
Presuming that no new shares are given to the cofounders (it is possible to give shares to the cofounders at any stage at the prevailing valuation) at this stage, Uncle Faroon receives 8,825 shares (58,825 – 50,000) of face value ₹10 each.
What is the value of each share now?
We now know that the value of 58,825 shares = ₹133.33 lakh
Value of one share = ₹133.33 lakh ÷ 58,825 = ₹226.66

[*This means that the value of each share, which was only ₹10/- at the beginning has now appreciated to ₹226.66. In case the cofounders want to receive new shares, they have to invest ₹226.66 for receiving each share. Also, notice the difference between the face value and the present market value.*]

The same calculation for the next round of investment is as under:
Basis:
Angel Haroon invests ₹100.0 lakh for 20% equity at a post-money valuation of 100/0.2 = ₹500.00 lakh.
Therefore, post-money, 58,825 number of shares of the venture = 80% of the company (100 – Haroon's 20%)
The total number of shares after allotment to angel Haroon = 58,825 ÷ 0.80 = 73,532
Haroon received = 20% of 73,532 = 14,707 or 73,532 – 58,825 = 14,707
Value of each share now = ₹500,00,000 ÷ 73,532 = ₹680 per share (face value of ₹10 each).
This is the market value of each share of the venture with face value of ₹10 each.

The above calculation shows that percentage holding may be estimated directly or through estimating number of shares held.

New ventures approach to different types of investors as they make progress. The most formal investors are the angels, venture capitalist, and private equity funds. These investors may prefer to invest their money in three different instruments, namely, preference share capital, equity capital, or debt. Investments in preference capital and debt may have preconditions to be optionally converted into equity capital after a scheduled time or at a predefined event.

If the investors invest in equity shares, the percentage holding, and the distribution of liquidation proceedings are straightforward. After payment to secured creditors and operational creditors, whatever money is left is distributed pro rata, i.e., proportional to their equity holding. However, angels and VCs usually prefer to invest in preference capital and the estimation of the share of money under liquidation event is subjected to the specific terms & conditions of the preference capital.

The forms/structures of the two conditions determine the amount to be received by the investors in the event of liquidation:

1. Liquidation preference, 2. Participating or Non-participating

Liquidation preference (how they decide to get their principal money back): Liquidation preference delineates how many times of the invested fund the investors should get back.

- **Liquidation preference can be of the following types**
    - no liquidation preference – (The investor receives zero times their investment under this clause. But they will receive money under the other clause, i.e., participating clause)
    - 1X liquidation preference: get exactly what they invested.
    - nX liquidation preference: the investors are to receive 'n' times the money they invested.

- **Participating & Non-Participating (receiving money proportional to % holding in the venture)**
    - Participating means the investors' money is converted into equity to determine their percentage holding and the liquidation proceeds are distributed between the equity shareholders on a pro-rata basis.
    - **Participating may or may not coexist with liquidation preference. If there is no liquidation preference, the money is distributed based on percentage holdings. Alternately, say there are 2X** liquidation preference and participating preference. The investors will take two-times their invested amount first. Whatever will be left, they will share it pro-rata with other equity shareholders.

Let us understand with an example:

Say a business angel (BA) group invests ₹50 lakh for 25% of a venture. The venture is sold for ₹100 lakh.

Case I: no liquidity preference (implicitly means the BA has invested in participating preference shares)

The BA group would receive 25% of the proceeds, i.e., ₹25 lakh, and lose the rest of their original investment. The entrepreneur or common shareholders would receive the remaining ₹75 lakh.

Case II: BA group has a 1X liquidity and non-participating preference shares

The term 1X liquidation preference means one-times the amount invested. Thus, the BA group would receive ₹50 lakh that they originally invested. The entrepreneur or common shareholders would receive the remaining ₹50 lakh. [If the investor would have 2X liquidation condition, they would receive 2 times their investment, i.e. 2 X 50 =₹100 lakh, meaning that they would take the entire ₹100 lakh and the cofounders would receive nothing. The same will be the case if there is 3X or more liquidation preference. Of course, investors will receive a maximum of the money available and no more.

Case III: BA group negotiates a 1X 'participating preference': Here, both liquidation preference and participating preference are present.

By dint of the 1X participation clause, the BA group receives one-times their invested sum, i.e., ₹50 lakh. They also participate in the equity and thus, receives 25% of the remaining money. Remaining money = ₹100 – ₹50 = ₹50 lakh. So, the investors receive a further sum of (25% 50=) ₹12.5 lakh, making the total at ₹62.5 lakh. The entrepreneur or common shareholders would receive only ₹37.5 lakh.

There may be more complex conditionalities that would protect the interest of the investors. Founders must read them carefully to avoid nasty surprises later.

Today's Story: RIVIGI

Gazal & Deepak of Rivigo – the founders of the relay truck business model

Empathy to understand a problem, define it completely and innovating a solution – a recipe of achieving a perfect product-market-fit

Gazal Kalra is an MBA from the Stanford Graduate School of Business and **Deepak Garg** worked in Mckinsey for over a decade and was deeply associated with the engineering and automobiles sector. Together, they created

Rivigo owns 3,000 trucks covering over 29,000 pin codes spread over the entire country. It has also established a vast network that consists of 200 branches and over 70 pit stops! The company has become a unicorn in 2019.

- Though economy was growing, truck sales were not.
- Huge backlog of transportation of goods.
- Huge price asymmetry due to transportation delay.
- The problem lay with truck driver unavailability.
- Truck drivers have been marginalized and looked at as outcasts.
- 'Why don't you consider the option of becoming a truck driver?' They took great offence to the question. One guy said no one would marry him if he took that option, while another said he had studied till Class 8 not for such a job."
- It is perceived to be a high-risk job because of poor living conditions, vulnerability to contracting HIV, drug, and alcohol addiction, and pressure from truck owners to drive more and faster.

The Business Process

The relay process: Suppose one truck starts its journey from Kolkata to Bhubaneswar, another truck would begin from Bhubaneswar exactly at the same time for Kolkata. Rivigo would have a resting place somewhere in between the two cities, say at Balasore. When the Kolkata truck would reach Balasore, the truck from Bhubaneswar would also reach there. The two drivers would take some rest and have foods and exchange their vehicle. The Kolkata driver would now drive the Bhubaneswar truck to go to Kolkata and go home the same day to spend quality time with family. The similar is the story of the driver from Bhubaneswar.

All drivers can compulsorily have work-life balance. They get better salary, better clothes, and better life. Transporters are happy as their truck takes less time for shipments and earn more money on per-truck basis. Businessmen are happy as their shipments are reaching destinations faster.

- No driver would drive for more than four-five hours at a stretch and would return home the same day.
- The mobile app the company has built for the drivers also makes life simpler by proving a one-stop solution for all their needs. The app, more image-based than text, is available in 11 languages.
- Integrating the driver back into the community and society.
- Drivers are called pilots and are well respected.
- Delhi-Pune (1,350 km) shipment usually takes 70 hours. Rivigo shipped it in 23 hours.

Table 1: Funding rounds, quantum of fund, corresponding events

Funding round	**Pre-Seed**	**Series - A**	**Series - B**	**Series - C**
Stage Fucus	Proof of concept/ Prototype	Revenue growth	Growth	Large scale expansions
Common elements of growth	Hiring	Development operations, branding, marketing	Hiring, market expansion, buying businesses	Acquiring business, international market
Quantum of investment	Within one million dollars	Around 10 million dollars	>10 & <$50 M	In the range of 50 million dollars