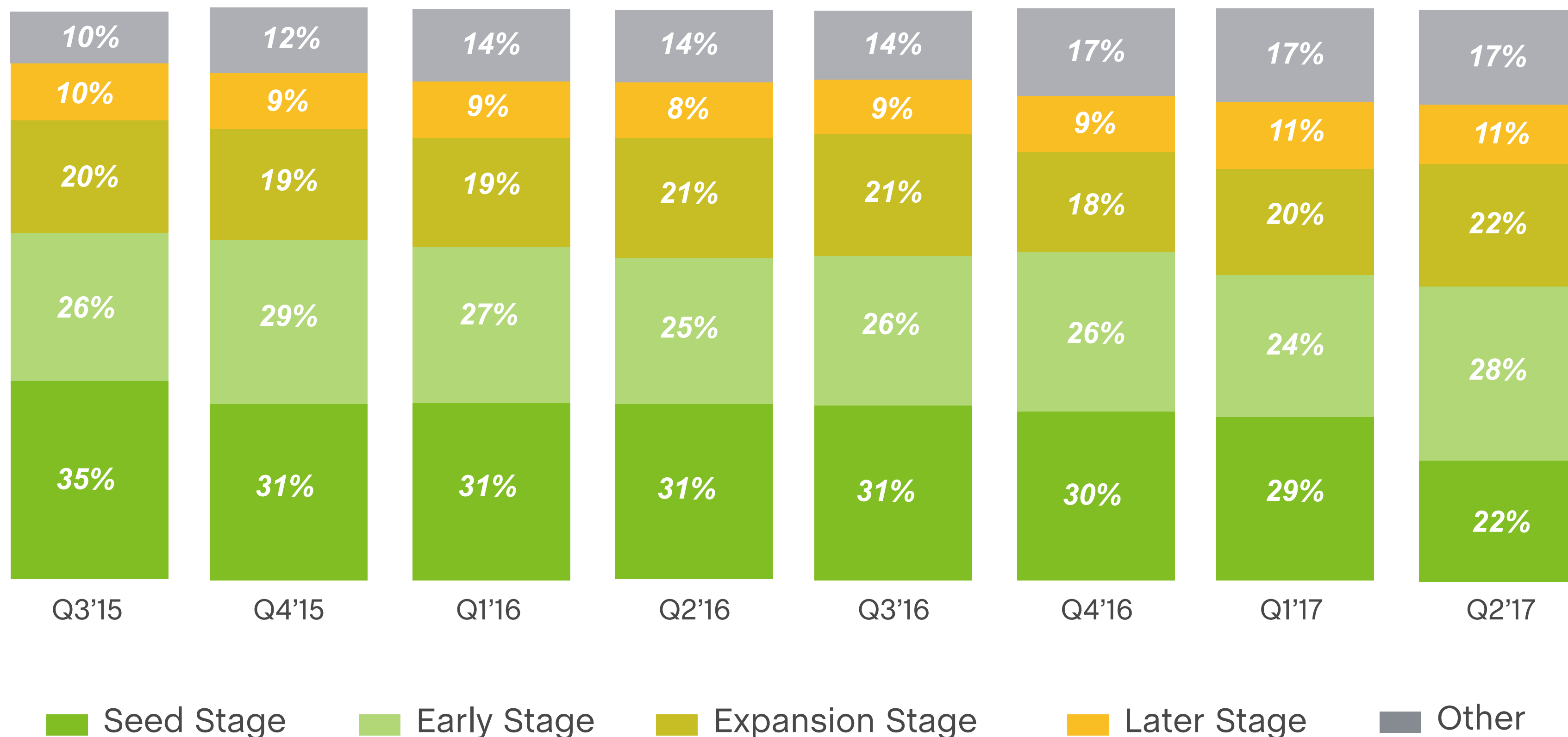
Founder Basics:

Raising Strategic Venture Capital Funding

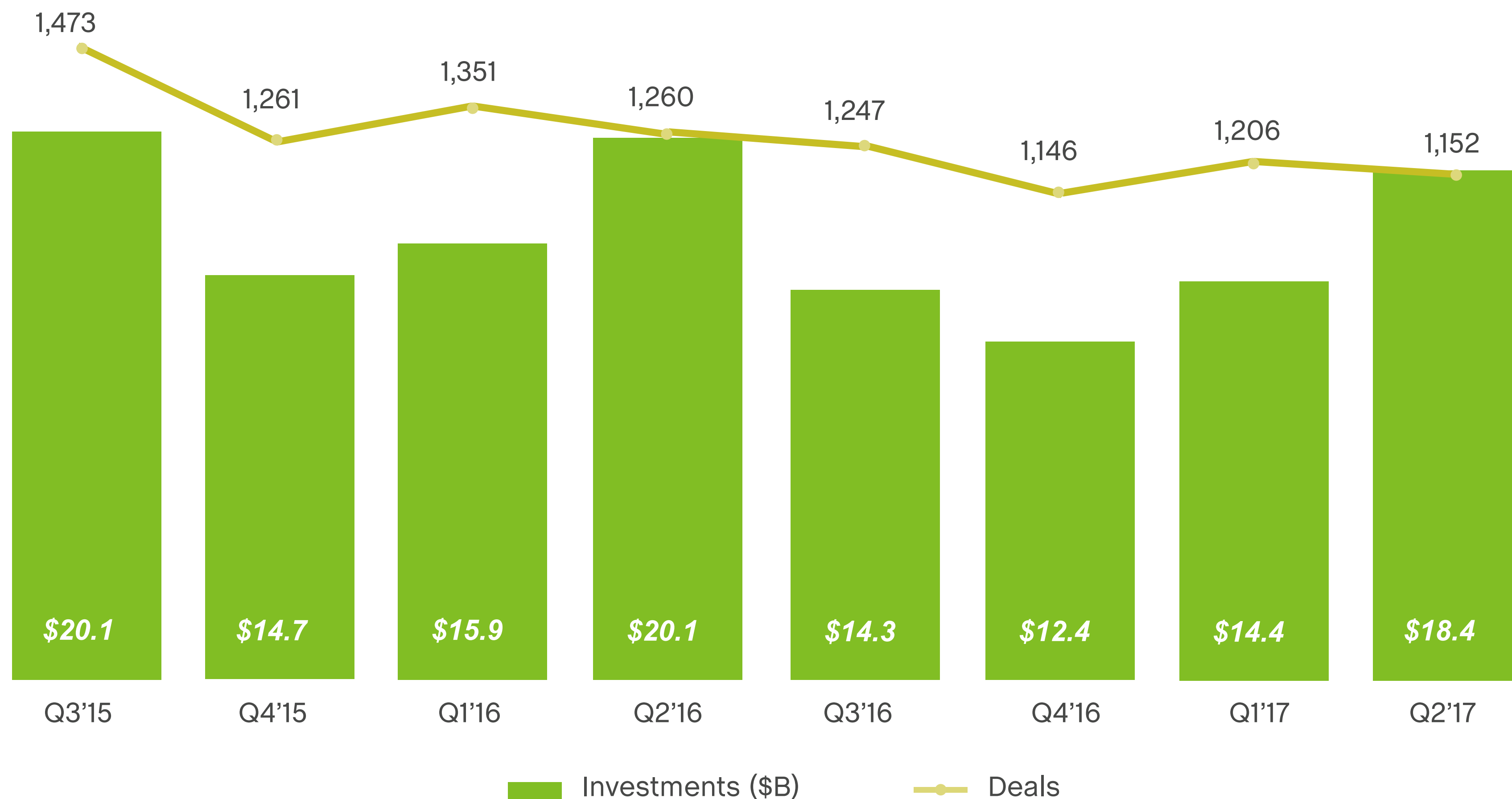
The Venture Capital (VC) ecosystem has seen a resurgence in the second quarter of 2017. In a turnaround from a sluggish Q1, U.S. startups raised $18.4 billion across all equity stages, from seed through late-stage growth rounds in Q2.



Source: PwC | CB Insights MoneyTree™ Report Q2 2017

© Exous | www.exous.com

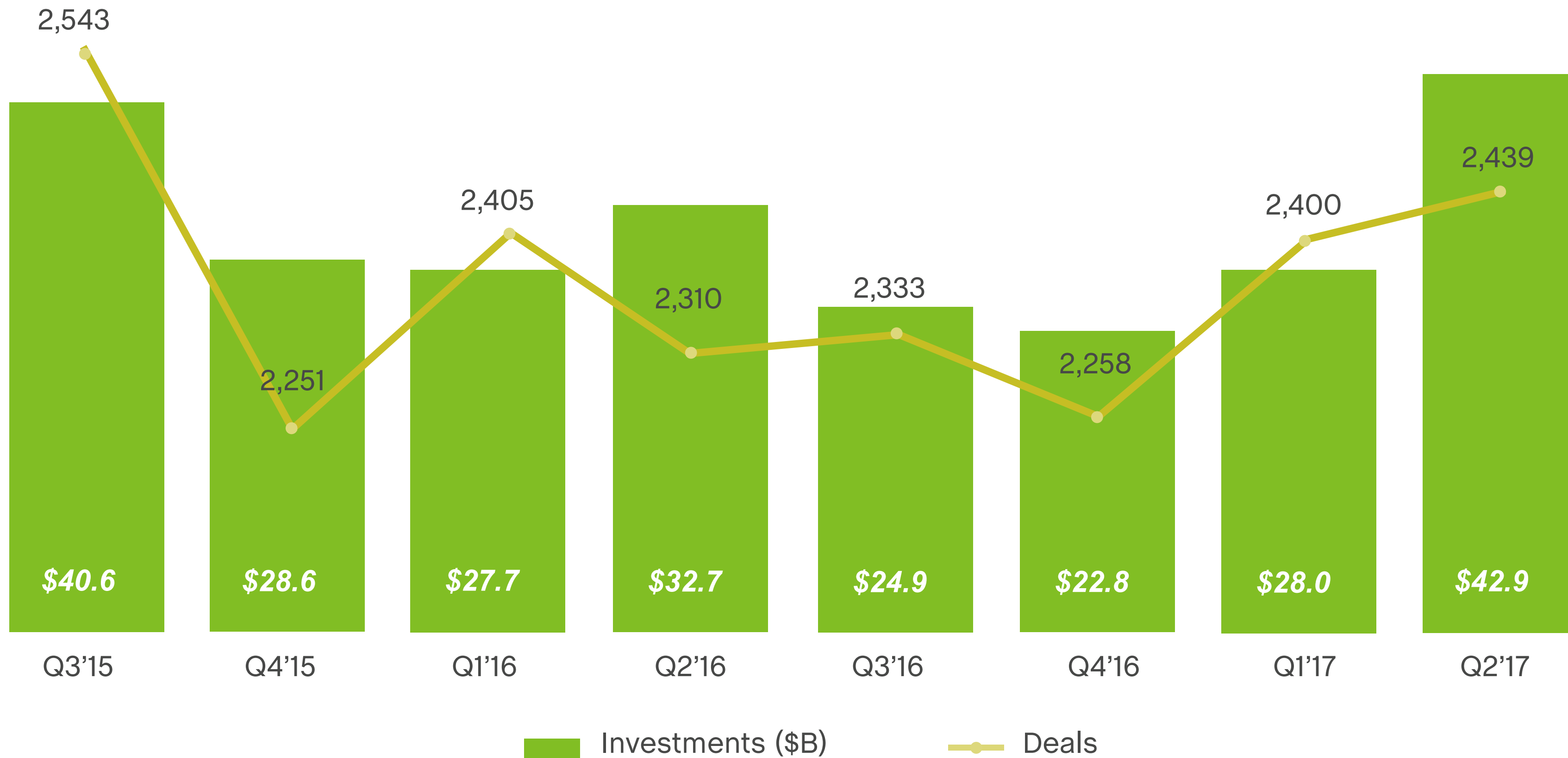
Strong mega-deal activity, alongside the $1 billion + valuations reached by nine new VC-backed companies, and heightened corporate activity have contributed to a 27% increase in U.S. venture-backed funding since last quarter.



Source: PwC | CB Insights MoneyTree™ Report Q2 2017

© Exous | www.exous.com

exous

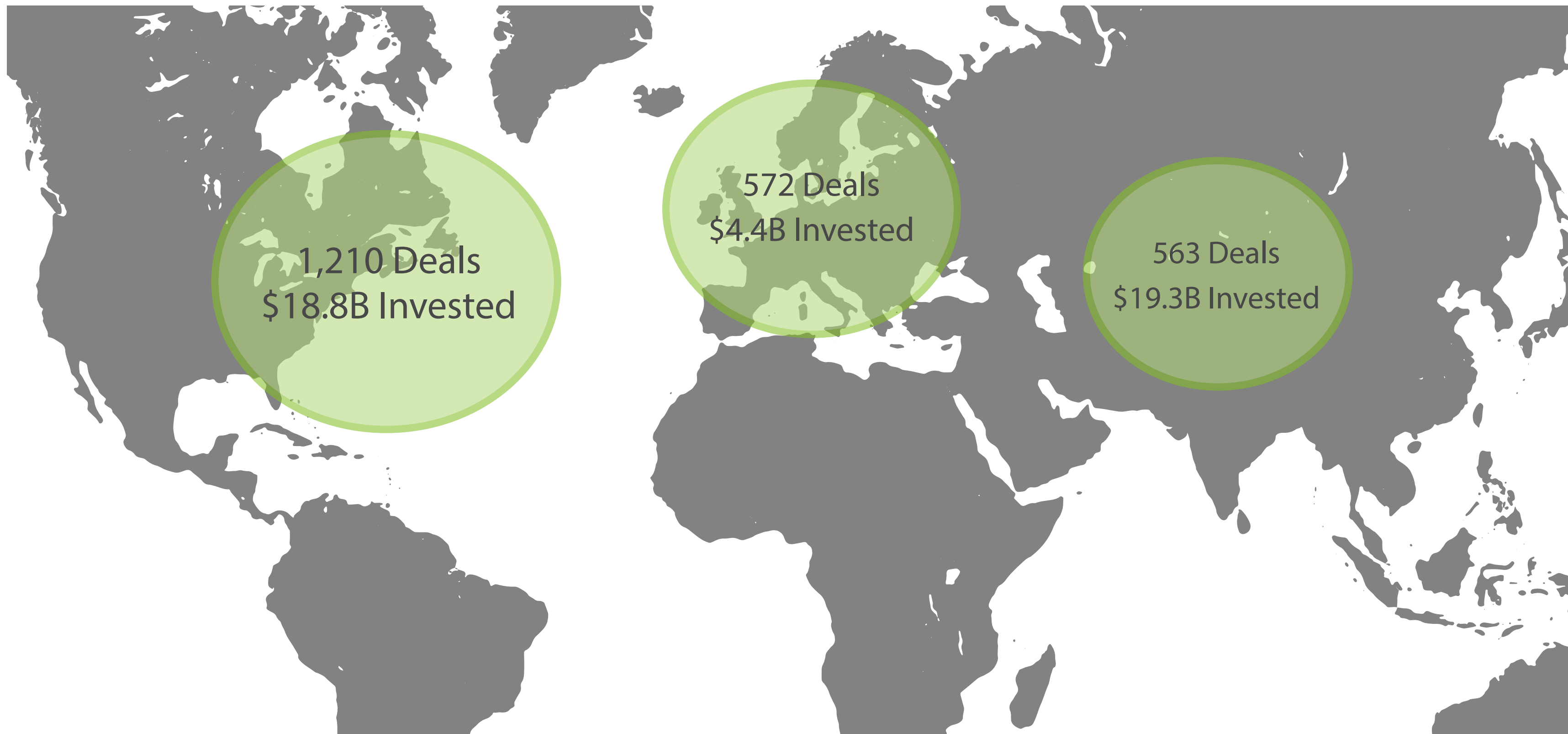


Source: PwC | CB Insights MoneyTree™ Report Q2 2017

The global VC landscape has seen even stronger gains, with an overall 53% surge in financing as Asia saw a doubling in funding from Q1. With mega-round activity trending upwards across the globe, Asia saw quarterly funding surge 103%, driven by five massive deals of $1 billion or more. These far-reaching milestones have positioned both European and Asian markets to hit eight-quarter dollar highs in funding activity.

© Exous | www.exous.com

exous



Source: PwC | CB Insights MoneyTree™ Report Q2 2017 [image source: freepik]

In response to the current environment, where mega-round activity and unicorn startups continue to reign supreme in the U.S. and across the globe, Exous helps emerging startups navigate the fundamentals of strategic VC funding.

© Exous | www.exous.com

Equity Funding Levels, The Basics

Initial Funding Round: Pre-Seed and Angel Investment

As a starting point, startup founders should tap their extended networks for initial, small scale investments — this includes, but is not limited to, friends, family, self funding, and initial angel investments.

Pre-seed investments, typically in the range of $150,000-$500,000, are integral to getting a startup off the ground.

Startup incubators and accelerators, numbering in the thousands nationwide, can serve as an important source of funding at this stage as well.

© Exous | www.exous.com

exous

Financial Reporting Guidelines	Minimal financial reporting is needed at this level, though an initial financial reporting framework should be in development.
Our Advice	No matter what level of funding you are pursuing, we recommend getting into the habit of implementing standard financial reporting practices, and more importantly, defining the key performance indicators (KPIs) for the business. The sooner you determine your core metrics (i.e. your cost per employee, number of projected clients to onboard per quarter, average contract size, number of employees needed for client implementation, etc.), the better positioned you will be in successfully executing your plan and being ready for an equity round of funding.
More Advice	Keep an eye on what advantages or privileges (i.e. guaranteed board seats, veto rights, business involvement, etc.) you ascribe to pre-seed investors — these could limit the company's ability to attract institutional investors. If forced to give these privileges out, the founder needs to make sure that they become null and void upon institutional investment. You do not want your pre-seed investor holding leverage over your company.

© Exous | www.exous.com

Seed and Angel Funding Round

This is the first serious round of funding, generally $1 million or less, that founders will seek from outside investors (i.e. angel investors and early-stage VCs) to move their startup to the next level. Angel investors, who can be involved in both pre-seed and seed levels of funding, will typically provide smaller amounts of funding in comparison to VCs, though may still have an active role in the business. At the seed level, startups should be past their proof-of-concept and need to have demonstrated traction in the marketplace. This round is designed to support essential activities that are tied to building and refining the product or service. This round may not be necessary if the initial round of funding was large enough to carry you to Series A funding level and beyond.

Financial Reporting Guidelines	Financial reporting at this level is usually limited to tax compliance requirements. If you don't have a financial operation at this stage, it is time to hire a VP of finance or controller, at a minimum. Your CFO function should either be outsourced or in the process of being brought in-house.
Return Expectations	This is a high risk/high return level of funding. Investors expect a 5x + return on their investment.
Our Advice	Financial reporting does not have to be perfect on day 1, nor does it have to be overly complicated. Start with the basics and expand as the business moves through the stages of its growth cycle. Be conscious of the fact that your financial reporting needs and their associated complexities will change as your business evolves.

© Exous | www.exous.com

Series A Funding Round

This funding round generally sits at or above the $3-5 million range, where founders begin pitching to the leading VCs in their respective industries. Potential investors will be looking for a growing user base alongside monetization of the product or service at this stage.

Financial Reporting Guidelines	Financial reporting requirements start to take shape at this level; and startup founders should take all their financial activities in-house. This starts by bringing in a CFO to oversee these operations.
Return Expectations	This is a relatively high risk/high return round of funding. Investors expect to realize a 3-5x return at this stage.
Our Advice	We consider this round of funding the most crucial in the lifecycle of the startup. This is where the business has to progress from the trial-and-error of defining its business model, to a more established structure driven by execution and growth.

© Exous | www.exous.com

exous

Series B, C, D... Funding Rounds

Future funding rounds will mark at or above the $5-10 million range, and could reach up to $50 million + at later stages. Investors at these levels will begin to include large-scale, well established funding institutions who will be looking for increased market share and revenue. Typical investors at this stage are private equity firms; and the funds are generally used for rapid business expansion to capitalize and maximize on the market opportunity for the business. These rounds are also used for allowing the founders, management team members, and/or initial investors to partially cash out their investments, and in very limited cases, fully cash out of their ownership stake.

Financial Reporting Guidelines	Reporting requirements become more sophisticated, with well-defined financial metrics established and monitored on a monthly, quarterly, and yearly basis.
Return Expectations	This is a moderate risk/moderate return round of funding. Investors expect to realize a 2-3x return at this stage.
Our Advice	You will want to use these subsequent investment series very carefully — pay attention to their dilutive impact on existing shareholders and any stringent terms attached with such investments, given their moderate risk/return objectives.

Debt Financing

As an alternative or complement to the equity funding levels previously described, startups may decide to use debt as a financing vehicle. This involves its own complexities that will be covered in more depth in a later whitepaper. Here's what you need to know now.

While founders can avoid giving up a stake in their businesses, the trade-offs with debt over equity funding usually span 3 things:

1. higher interest rates on debt owed;
2. strict terms and financial covenants; and
3. rigorous reporting requirements.

Our Recommendations

> Startups should consider debt financing along with Series A funding rounds and beyond.
>
> Debt financing has to be used carefully as it can be detrimental to business if not properly managed. Too much debt can even hinder your ability to operate your business and raise additional funds.
>
> Founders need to keep in mind that debt is always serviced first in any liquidity event, before money is distributed to any shareholders.

© Exous | www.exous.com

Strategic Fundraising Checklist

Start with the Basics

Before pursuing equity funding, startup founders need to get familiar with a few business concepts and basic terminology.

These include an initial business plan, valuation (pre-money/post-money), capitalization table, and term sheet, all of which are fundamental elements in negotiating with a potential investor.

© Exous | www.exous.com

exous

Business Plan	Document that provides an overview of the business, from strategy to financial forecasts. This should make the case for the startup's long-term potential. Apart from unique and disruptive technology capabilities, most VCs will be on the lookout for subscription- or recurring revenue-based business models.
Valuation	The process in which an investor determines the worth of your business. This can involve an array of factors including but not limited to the uniqueness of your technology, market size, revenue levels, and market traction. Valuation can be pre-money or post-money. Pre-money valuation refers to a startup's value before it receives a round of funding, post-money valuation represents a startup's value after it gets a capital injection.
Capitalization (Cap) Table	Table measuring business ownership and forecasting how new investments will dilute ownership percentages and the respective values of each shareholder.
Term Sheet	Non-binding letter of agreement that sets the basic terms and conditions for investments (i.e. investment type, accrued interest/dividend rate, agreed-upon company valuation, etc.).

© Exous | www.exous.com

What to watch for:

Startups need to be on the lookout for investment terms related to preferred stocks, the primary investment instrument of VCs. These include terms like liquidation preferences and whether they are participating or nonparticipating. Founders will need to understand the mechanics of preferred stocks and make these considerations during the negotiation process as this has the most economic impact on the existing common stockholders.

Liquidation Preference: usually linked to preferred stocks, this feature gives investors a somewhat more "guaranteed" return during a liquidation event (typically a sale of the company). The preference is usually negotiable based on multiple factors including, but not limited to, the company valuation, the interest/dividend attached to the preferred shares, participation or nonparticipation, etc. The liquidation preference amount (typically around 1x the initial investment but with the potential to go up to 2 or 3x) is generally paid from the sales proceeds of the company ahead of the common stockholders, and right behind the debt holders.

© Exous | www.exous.com

Participating: this term is applied to the preferred stocks, and enables investors to not only get their total liquidation preference amount in the case of a liquidation event before all common stockholders, but converts their preferred stocks to common stock, allowing them to participate in the distribution of remaining funds alongside the other common stockholders. This is also referred to as "double dipping." This is something that VCs usually want as part of every deal as it provides them more protection on their investment, but can definitely be negotiated out or capped based on a successful outcome to the investment.

Nonparticipating: this term is also applied to the preferred stocks and provides investors with the choice during a liquidation event between the greater of: (1) their liquidation preference amount as defined above; or (2) the amount of their preferred stocks converted to common stock. This feature provides more equitable terms to founders and existing common stockholders. This should be a founder's preferred feature in negotiation.

Although investors will sometimes try to lay out terms that integrate these elements to maximize their ROI, founders should be on the lookout for this, and not be afraid to negotiate these terms out according to their specific situation.

© Exous | www.exous.com

exous

Find the Right Investment "Fit"

Not all investments are created equal. Founders should ask themselves whether or not potential investors are in line with the values and interests of the business, have an understanding of the respective industry, and can communicate their expectations and exit strategy clearly. It is important that interests align between founding stock holders and institutional investors in order to ensure everyone is heading towards the same goal.

What to watch for:

Once you start going down the Series A round of funding and beyond, you need to examine a few key factors when dealing with potential VC investors:

Where in the cycle is the VC fund? VC funds are usually structured to have a ten-year fund life. You don't want a VC fund in its later years investing in you. An older fund will have a much shorter horizon, thus placing more pressure on you to deliver large-scale returns in a much shorter time span. Aim for VCs that are in the early- to mid-stages of their fund lifecycles.

How big is the fund? There may be a lot of data available regarding a fund size, but the most relevant information to startups are the dollar amount of the current fund and when that amount was raised (i.e. the fund "vintage"). It is common to see VCs with large fund sizes shy away from small investments. On the flipside, a fund that is almost tapped out is problematic in its own way. Founders need to be aware of all the limitations that a potential VC may have in terms of funding.

© Exous | www.exous.com

Set Your Startup Apart

Founders should not only develop a compelling, ROI-driven narrative for their startup, but come to the negotiation table with well-organized financial projections based on a solid and supported set of assumptions. Market positioning, technology differentiation, competitive advantage in the marketplace, and addressable market size are all elements that investors scrutinize. Being able to distinguish yourself, and having the data to back your narrative claims are key.

What to watch for:

One aspect that most business founders undersestimate or lack understanding for in their current business is their burn rate. A startup's burn rate is essential for determining the lifetime of a funding round. Founders need to understand their spending habits, calculating a monthly burn rate against income that will inform cash runway. As a rule of thumb, Series A funding and beyond should be projected to last you one and half to two years. As the funding lifetime closes, a startup should either become cashflow neutral (break-even), cashflow positive, or otherwise be ready to embark on its next funding round .

© Exous | www.exous.com

Consider Hiring an Agent

Given the high stakes nature of equity financing, and the fact that founders often are not familiar with the VC ecosystem, any mistake could mean a tremendous amount of financial loss to a startup. In the same way that you would evaluate hiring a realtor to represent you in the promotion and sale of your home, considering an agent for your startup's equity funding rounds should be part of your strategic fundraising process, regardless of your funding level.

Our advice:

> Make a determination of your business advisory and equity funding needs by evaluating your current standing. Have you exhausted your current funding network? Are your financial documents readily available? Are your business models and assumptions sounds? How compelling is your investor pitch?

© Exous | www.exous.com

Conclusion

While VC funding shows no signs of abating in the U.S. or abroad, founders need to formulate a comprehensive, ROI-driven strategy (or hire an agent to do so) as they head into any stage of equity funding. Determining the appropriate funding level to pursue, evaluating investors that are in line with your startup's values, and developing a sound value proposition that sets your business apart, are integral elements of your strategic funding checklist for success.

© Exous | www.exous.com

About Exous

Exous employs a full suite of strategic, operational, and technology consulting services to resolve complex business challenges and elevate your startup to the next level. Over the past 25 years, our executive leadership team has serviced over 60 organizations, from FinTech firms to nonprofits, by applying a data-driven, agile technology approach to resolve complex business challenges, creating over $100 million in shareholder value and raising over $60 million in capital funding. From digital-first enablement and strategic funding, to Artificial Intelligence (AI) integration, Exous has the expertise and the knowhow to make innovative business concepts and objectives a reality.

For more information, please visit http://www.exous.com or contact us at info@exous.com.

Sources

(1) PwC | CB Insights MoneyTree™ Report Q2 2017. (n.d.). Retrieved from https://www.pwc.com/us/en/moneytree-report/assets/MoneyTree_Report_Q2_2017_Final_F.pdf.

(2) CB Insights. (2017, March 2). Industries Of The Future: The Trends, Companies, And Categories The Top VC Firms Are Betting On. Retrieved from https://www.cbinsights.com/research/smart-money-startup-funding-trends.

(3) Rowley, J. (2017, July 11). Inside the Q2 2017 global venture capital ecosystem. Retrieved from https://techcrunch.com/2017/07/11/inside-the-q2-2017-global-venture-capital-ecosystem.

(4) Suster, M. (2010, April 2). Does the Size of a VC Fund Matter? Retrieved from https://bothsidesofthetable.com/does-the-size-of-a-vc-fund-matter-fb58594de8e6.

© Exous | www.exous.com

Share this ebook:

@exousinc | www.exous.com