Startup and Early-Stage Funding

Due to their high business risk, early-stage firms have to assume a low financial risk profile.

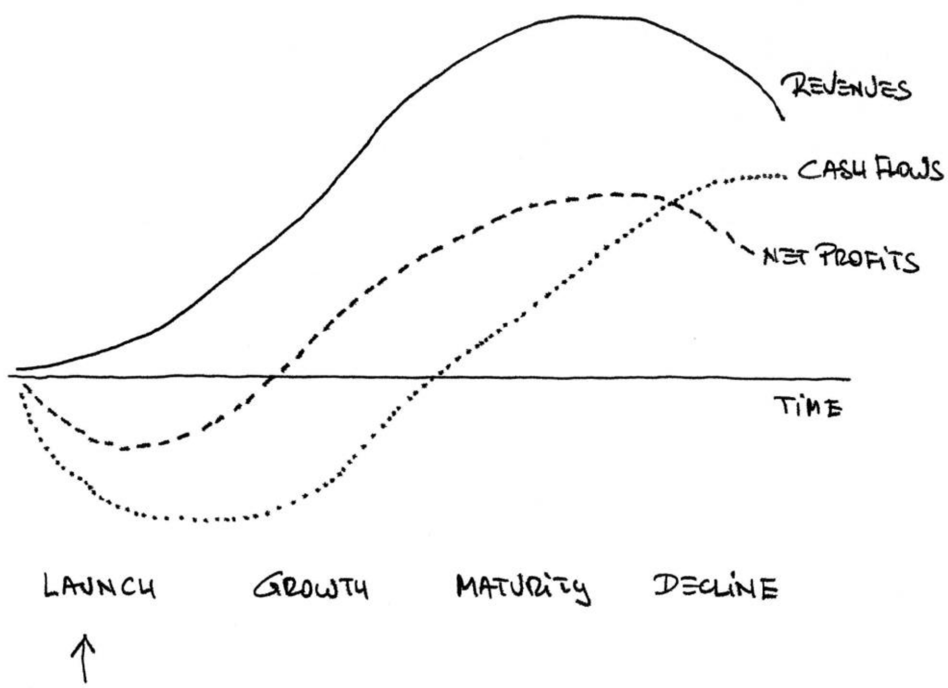
Initial or founding capital in early-stage funding rounds typically serves the purpose of kick-starting research and the development of a product prototype. Such funds are typically raised by the company founders, also taking the majority of ownership in the company. These initial funds will often be complemented or followed by minor, low-value and -volume investments, perhaps supported by friends and family. - In addition, seed investment may be obtained from business angels: Their respective contribution – which, next to funding, should ideally also include an active involvement, such as mentoring, coaching and providing network access – will usually be in exchange for equity, maybe also for convertible debt. – In this stage, investment documentation is typically light, merely including – among others – a shareholders' agreement and a short form subscription agreement with limited or no warranties.

A Venture Capital Fund (VC) typically invests in a company within reach of generating at least some revenues. A first-round VC investment is often also referred to as 'A round'. Companies at this stage will be unprofitable and financing will be used foremost to cover negative cash flows caused by operating costs, capital expenditures and working capital funding. VCs usually make investments larger than that of current investors and therefore demand a material equity stake in return. VCs will expect transaction documentation providing specific investor protections: The company and founders will enter into a long form subscription and shareholders' agreement, backed by warranties, with constitutional documents containing preferential rights for series A investors, such as liquidation preferences and anti-dilution provisions.

Subsequently, so-called series B, C, D investment rounds etc. may follow enabling the company to scale its business. At this stage, also private equity funds or strategic investors may join the VCs with the size of investments increasing as the value of the company grows. – As such investments near the exit stage for these investors, increased focus will be on liquidation preferences and reorganization mechanics.

The engagement of strategic investors participating in these funding rounds is referred to as vendor funding. Such an involvement can be highly beneficial: It may accelerate progress through shared knowhow and market access. On the other hand, though, an investee loses flexibility in view of a later exit, as the strategic investor will probably have a first right to acquire stakes of divesting shareholders. Or, it may decide to remain in the firm longer-term. Therefore, having a strategic investor may diminish the attractiveness of an acquisition by other, competing strategic players. And this, in turn, may not only reduce the value of a firm but make an exit for other shareholders at times hard to achieve.

Institutional investors usually participate in pre-IPO funding rounds with a view of exiting the company within an agreed period of time, often within 3-5 years. This exit can be achieved by way of an Initial Public Offering (IPO) or an M&A transaction. During this crucial phase, the company may seek bridge / pre-IPO funding to support its continued expansion, whilst underway of preparing the exit strategy for some of its investors. – The firm´s pre-IPO reorganization may require collapsing various share classes into a single one that will eventually be admitted to trading. Further, the firm will need to establish investor relations, ensure that appropriate board members have been appointed and start entering a dialogue with one or more investment banks to prepare structuring the exit strategy.



START-UP / EARLY STAGE

BUSINESS RISK	HIGH
FINANCIAL RISK	LOW
FUNDING INSTRUMENTS	EQUITY
FUNDING SOURCES	SELF, FRIENDS, FAMILY ANGEL INVESTORS, INCUBATORS VENTURE CAPITAL FUNDS
DIVIDENDS	NO

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