



Navigating the Funding Universe

Launching new ventures

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Stages

- Seed and startup
- Growth or expansion

Types of financing

- Gifts / donations
- Debt
- Equity
- Convertible debt

Investors

- More details to follow

Sales (exits)

- Trade sale
- Initial Public Offering (IPO)
- Management buyout (MBO)

Launching New Ventures

Welcome back to segment 4.2 *Navigating the funding universe*. Today we are going to talk about different types of funding, we are going to talk about the stages of funding, the types of financing, different kinds of investors, and sales or exits of your business.

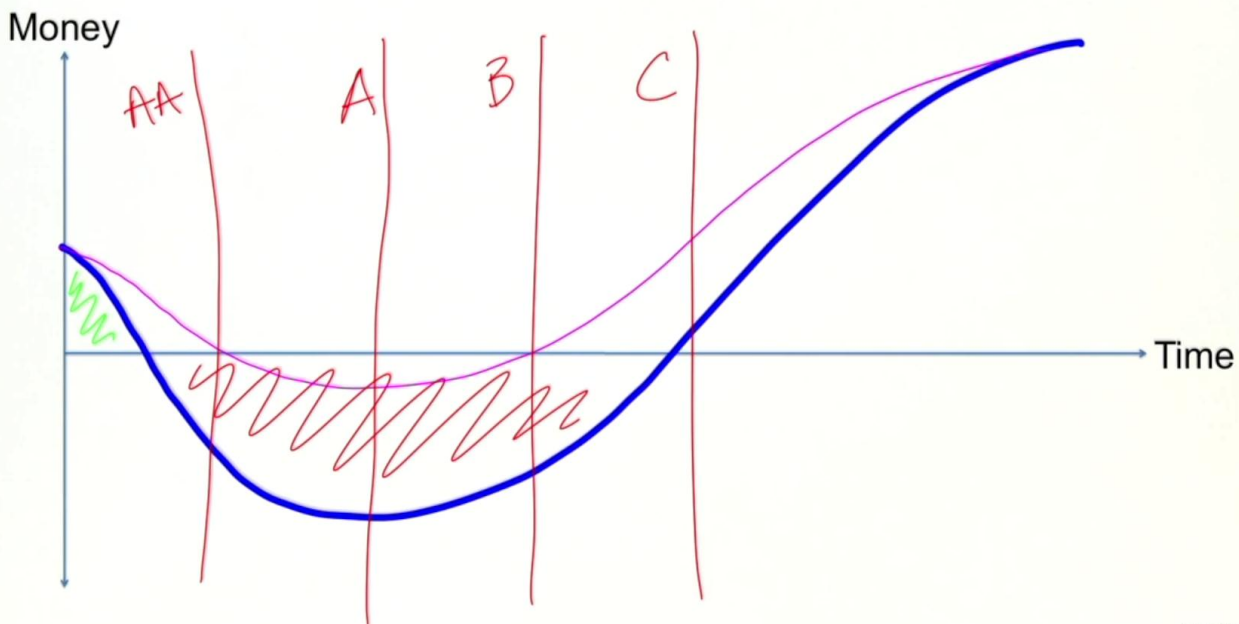
Notes

Summary



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Stages of venture financing



Launching new ventures

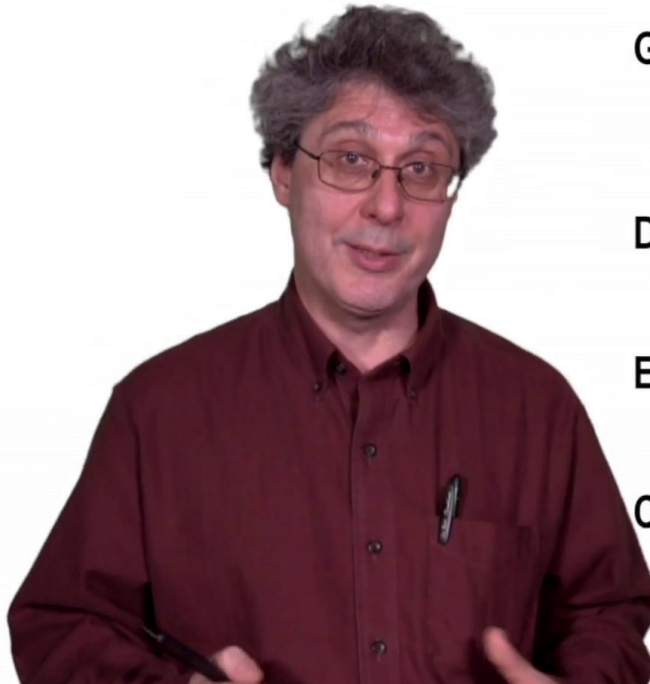
Let's talk about the stages of financing for your venture. We've previously discussed the timeline of your investment and how much money you will need, that was in the last segment. Now, we are going to look at this graphic, which is from the last time, and we are going to see when different types of financing are most appropriate. What we have covered last time, was the seed financing versus the expansion financing. But that can be further subdivided. So, in this graph, you'll see more or less seed financing, and seed financing might be divided into different categories. And then, there could be different rounds of financing over time. Usually, we consider the first round of financing where equity is given up, where partial ownership - we'll talk about that more in a few minutes - We called that the series A financing. And then, as expansion financing kicks in, we would collect more rounds, we'll have more rounds of financing, and we would call that the B round or the C round. So, every time we have more financing we have additional letter of the alphabet. Now in some cases, the early stage seed funding is often called seed funding or early stage funding, but it's also sometimes called AA, series AA. Usually, AA refers to the round where is no equity given in the company, so there is no ownership or control of the company given out, but there's some money raised.

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Summary



0m 26s



Gifts / donations

- Cash or in-kind contribution
- Given with no expectation of anything in return

Debt

- Promise to pay back, with interest

Equity

- Ownership share of company

Convertible debt

- Start with debt with option to convert to equity

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Now let's discuss different types of financing. We are going to talk about four different types of financing today. There are actually many more kinds but these are the main four that you'll probably hear about and that you'll probably use. The first one is a gift or donation and that means that you are receiving some money with no expectation that you are going to give the money back. Then we have debt financing, where there is an expectation that you're going to give the money back possibly, with an interest payment; so you'll give them more back than what you borrowed from the investors. And then, we have equity financing, which is basically, an ownership share of the company. Finally, we're having convertible debt, which starts out as a loan and then, possibly converts to an equity position in the company. So let's go through each and each of these, one at a time, and talk about the pluses and minuses of these different options.

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Summary



2m 16s

Types of financing—Gifts & donations



- Cash or in-kind contribution
- Given with no expectation of anything in return

Advantages: No strings attached, no consideration

Disadvantages: Time to raise gifts, amounts are often quite small

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The first one is gifts or donations. And these are cash, or in-kind contributions that someone provides to the entrepreneur. They are given with no expectations with getting anything in return, so it's really "free money", if you think about it. Now why would you want to have a gift or donation? It's clear that there is no strings attached to this, there's no consideration. Consideration is when one party gives up something to another party in exchange. So, in this case, you're really just getting the money. The disadvantage of this approach is that it takes time to raise gifts. We've mentioned before on one of the prior segments; raising money is not free. It takes time. It costs you something. And in this case, you are going to raise a lot of gifts that can often be quite small, and you might spend up spending a lot of time to raise this sort of money because it's hard to attract people to give you gifts, unless you know them very, very well.

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3m 19s



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The second type of financing that we want to talk about today is debt financing. Now debt financing is when the entrepreneur promises to pay back the money with interest. This is a loan, it's called a loan, and it occurs for a certain amount of money. I am borrowing \$10,000. I need to pay back \$10,000. The loan itself is often called a *note* or a *bond*. Bonds are not usually used to start up companies, but a note refers to the loan instrument itself. In many cases, with startup companies, the debt is not collateralized, in other words, it's an unsecured loan. They are lending you the money and you don't have any assets to sell off in case you don't pay them back. Therefore, the borrower has to pay interest, and the interest is predecided. Of course, some lenders, like your family members may give you a loan with no interest. They want to get their principal back. But most investors will want to receive interest; It's also called the *coupon rate* of the loan. The loan usually has a fixed time for repayment, one year, two years, five years, and that's called the *term of the loan*. The one thing that's interesting about the loan is that there is no ownership or decision-making power inherent in debt financing in general.

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Summary



0m 06s



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As long as you keep paying them back. If you don't pay your interest payments, in certain cases, the person who's made the loan might be able to force you into bankruptcy. But in general, they don't control your strategy, your marketing decisions, your product development. They don't have a say in running your business. So, what are the advantages of doing this particular type of financing? First of all, it's very simple, and the entrepreneur gets to keep the ownership and control of the company. The disadvantage is that you don't gain much from interacting with the loan officer. You can't ask him for advice on running your business. They are not experts in running a business. A huge disadvantage, of course, is that you need to keep generating cash. You need to keep paying back the loan every period, whatever that is, maybe it's a monthly payment, or a quarterly payment, but you need to keep paying that loan and it does eat up some cash. The third type of financing is called *equity financing*. This is where the entrepreneur gives up an ownership stake in the company. That means that the entrepreneur is receiving some cash from the investor, and in return, is selling a share of the company.

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And that means that the company it is going to have a certain *valuation*. The definition of valuation is basically, the total expected value of all of the future profits of the company brought back to the present dollar terms. For example, you might ask an investor to give you \$100,000 dollars, and you are willing to give up 25% of your company to receive that \$100,000 dollars. That makes your company worth \$400,000 more or less post-money. We call it post-money because the \$100,000 is actually included in the \$400,000 making it for one quarter, in other words, a 25% of the company. That money put it in that valuation, which is \$400,000, would be brought forward, in future rounds, and depending on how things change on the market that would be the basis of the valuation, that would be the pre-money valuation for the next round. If nothing changes. Now, of course, you might find out that the market is growing more rapidly than you thought before which would make your pre-money valuation grow in the interim. All of these details, this pre-money evaluation, how much you are expecting, how much of the company you are giving up, and how much the company is worth afterwards are specified in what is called a *term sheet*.

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0m 11s



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This basically gives the terms and conditions for the investment itself. Why would you want to go through all of this to gain some investment in your company? The first issue is that you can have a network and you can have advice from the people who make the investment. People often call this *smart money*, because that means the money is coming in, plus you can get the advice or the network from the investors. And another good reason for doing this is that this reduces the cash drain on the company, since you don't need to pay the interest like you would in a loan, you can then be more flexible with your business operations. Of course, the biggest disadvantage is the one I think maybe entrepreneurs think about this a little too much, is that they have to share the ownership and control of the company with the investor. That means that the entrepreneur is no longer the sole owner, or the entrepreneur or the founders and no longer the sole owners in the company but rather they are now sharing ownership in whatever percentage they agree upon with the investors. And some entrepreneurs are very nervous about giving up ownership and control.

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0m 13s



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There might be some legal reasons too, legal protections for the minority shareholders in this particular case which might also constrain the ability of the entrepreneur to do whatever he or she wants to do. The last type of financing that we want to talk about today is called *convertible debt* or *convertible note*. Now, that is debt that can be converted into equity later on. So, in the beginning stages the investment is treated as any other loan and the investor receives interest payments. However, at a certain point, which can be agreed upon in the term sheet, the investor has the right to take the value of the debt and convert it into equity. Now when can they do this? This can be set up in the term sheet to be milestone-based or could be time-based. Of course, there needs to be an equity round for this to happen, so that there is a valuation of the company. But it could be when the first equity round is closing, it could be in the second one, it could be other milestones when you've received a certain amount of sales, when you've received a profitability, reached profitability, or could be a time-based thing, like after one year or three years, if there is an equity round that creates a valuation of the company then we can convert the amount that was invested in debt and convert it into a partial ownership of the company.

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0m 15s



Stages

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Launching new ventures

What's the conversion rate? It's a little bit trickier to explain, but basically, to entice the investor to make this investment, you need to offer some sort of cap, a valuation cap, on the valuation of the company in the future. For example, if I were to lend you \$100,000, you might say to me, "Well, in the future if the company is worth more than \$1 million..." We will pretend for this particular exercise that it's worth exactly \$1 million, so you will end up with 10% of the company. If it's worth \$10 million, you still get 10% of the company because your valuation is capped. Otherwise, the investor might think, "Well, I could put in \$100,000 now, but if this company really takes off - which is what everyone wants - then I am going to be left with only 1% of this company, even if I took a big, big risk lending them this money in the early stages." That's why these valuation caps are set up as a bonus, or as an enticement to the investors. So, why would you want to do this kind of financing? It's becoming more and more common, there is definitely a trend toward convertible debt. It can be quicker to negotiate than an equity investment. And it definitely delays the valuation discussion.

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0m 17s



- Debt that can be converted to equity later on
- At first, the investment is treated as a loan and the investor receives an interest payment
- At a certain point, which can be agreed upon in the term sheet, the investor has the right to take the value of the debt and convert it to equity
 - Could be milestone- or time-based
- The conversion rate could be at whatever the valuation is at the time of conversion, or it could be “capped” to limit the risk of the lender

Advantages: Quicker than equity, delays valuation

Disadvantages: Pricing risks, “caps” are complicated, still owe money if no equity round

Some entrepreneurs don't want to decide too early on the valuation of the company. So, rather than go straight to an equity round, they might do a convertible debt and they would then postpone the first valuation of the company. Disadvantages, as you can see just from this short discussion there is some pricing risks on both sides. This is something that you need to have someone else with expertise look at. The caps can be complicated, and if there is no equity around, you're still paying that coupon, you are still paying the loan off, so you'd still owe money plus the principal, you still owe the principal to the original investor even if you never make an equity round.

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Summary



13m 22s



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Now let's talk about the investors. Who are these investors that are going to be throwing money at your business? There is a wide range of investors starting from - as you can see here on the list I have created - from friends and family, all the way down to strategic partners. So, what I wanted to do here is simply walk through each one of these, and talk about them briefly. What we'll do is, in the next few segments, we'll go through some of the more important ones here and give a lot more details about it. But for now, I just wanted to give you the definitions of these different sources so that you are fully aware of the sources. Let's start with friends and family. That's pretty obvious. You are going to be asking your friends and your family to be investors in your business. They can give you gifts, they can be part-owners in your business, that makes things complicated later on but it is possible, or they may lend you money. Crowdfunding is something that's relatively recent, but something that is fairly interesting for startup companies because you can make a pitch to a very wide audience on an IT platform, an information & technology platform, an Internet site.

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0m 21s



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You can pitch people who would either pre-buy your product before it's even done or in beta testing, or they may actually, depending on the platform, make an equity investment in your company. Banks, as we know, can lend money to companies. Foundations are often set up to fund certain causes, and they can be a very, very interesting source of donations early-on in the startup's life. Start-up competitions, business plan contests, etc., usually, they are competitive, you generally get some advice from the audience who are your panel of judges or jury and you can win prize money which could help fund the initial stages of a company. An angel investor is a wealthy person who's often made money as an entrepreneur in the past and would like to fund early stage businesses. Often, angels join together in big groups so that they can have a bigger impact on the company, in which case, the angel group meets regularly and entrepreneurs make pitches in front of the angel groups and the angel groups vote and decide whether they want to go in and make a bigger investment in the company. They would be getting equity in this particular case.

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0m 23s

Investors—who are they?



- Friends and Family
- Crowdfunding
- Banks
- Foundations
- Startup competitions
- Angels and Angel Groups
- Family Offices
- Venture Capital
- Strategic Partners

• Nobody (“bootstrapping”)

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A family office is something that is set up by a family, a family business, and it would be an investment vehicle like an institutional investor for that family. A venture capitalist is a specific kind of investor that make investments in startup companies usually, at later stages, and for more money - we'll talk about that next - and they are definitely interested in an equity position in the company, and they would like to see an exit event happening, because they raise money from other people who are trying to look for investments, then they take that money and they invest it in start up companies and then when the company exits, or has an exit event, then the venture capitalist take the money and pay back the original investors. And finally, a strategic partner is usually a large company that could be a potential customer or complementor, and that's a company that might be interested in acquiring a startup company. Finally, put on there just for reference, we say "nobody", because there is no investor, that's the bootstrapping mode, that means that you, as the entrepreneur, are making money from the operations of your business and you are using that investment to continue to run your business. So you pull yourself up by your bootstraps, we call that *bootstrapping*.

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17m 02s



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Great so now that we've discussed the different kinds of investors, what we want to do is to give a brief overview on what to expect in terms of the amounts of money you might raise from each type of these investors. That's what we are going to do now and then come back and do all the details in the next two segments, when we'll talk about seed financing next and the segment after that, we'll talk about expansion financing. So, for this case, what we are going to do is look at this slide, and we are going to just do a quick graph of the kinds of investors and how much money, roughly the range that you'd expect to raise from each of these types. So, on this slide, what you see, is on the left, we have a list of all the various types of investors and at the bottom, we have an axis which refers to how much money you'd expect to receive, roughly, from each of these types of investors. Just to give some idea of the scale, what I have done is I calibrated this scale on a log scale, and so, we are going to go from \$1,000 to \$25 million, and those are in dollars. You need to calibrate that to your own economy, to how much money you can raise; I'll give you some ideas on some of the equivalents here.

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0m 27s



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Let's start with the left side which is going to be \$1,000. And then, over here, we can draw here and then, we'll draw \$10 million here. So between \$10 million is about \$100K. Just approximately, two times the GDP per capita. Just to calibrate a little bit. Let's put here \$1 million. \$1 million. Roughly here that's going to be \$10,000. And then, up here, I would say just roughly, let's put just one more in. So, along this axis here then, we see the amount of money that one might expect to raise. And now, we are going to go through and we are going to draw a line showing a rough range and the typical amount that one might expect from each of these sources. The overall trend of this list is as you move down the list, the amount that you can expect to raise would go up and therefore, they would be used at some later stages, the higher amounts at the later stages, and the earlier amounts at the earlier stages, just as we've already discussed. The first one on the list is friends and family. That's where you ask your friends, family, and other people that you love, to give you money and/or to give you a very cheap loan. This is relatively small amount of money that can be raised.

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And a typical amount that might be raised on the order of \$25,000 dollars. Crowdfunding is where you use an internet-oriented platform to reach a large number of anonymous people, and they are what's even less than friends and family, on the order of \$7,000 will be a typical amount. So for banks, you are taking a loan from the bank typical amount lent is \$25,000 or so, and the range might be anywhere from the lowest amount, \$1,000 to even up to \$500,000. For foundations and public organizations, what you are doing is you are typically asking for grants and these tend to be roughly and relatively small amounts anywhere from let's say \$5,000 to \$200,000, and the typical amount would be on the order of \$10,000. Startup competitions: this is a contest where you pitch your idea, and you can win prizes. Prizes are usually on the order of \$10,000 dollars and they can range anywhere from \$1,000 up to \$50,000, somewhere in that neighborhood. For angels and angel groups there is actually a distinction. We are going to draw a distinction here between an individual angel and a group of angels working together.

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The earlier stage financing is going to be to raise money from an individual person and that might be on the order of \$50,000 to \$500,000 with the typical amount maybe on the order of \$200,000 or so. For an angel group, that would be a group of angel investors who invest together. Therefore, the amounts would be higher, typically, somewhere between \$250,000 and \$1.5 million. Typical amount might be \$1 million or so. Family offices are a little bit different in that generally, they are doing the investments for a single family. They usually do not make direct investments into startup companies. They would rather make indirect investments by putting a larger chunk of money into a venture capital fund, but occasionally, through some contacts or through luck, you might be able to engage a family office directly, in which case it's going to be on the larger side of the scale. And this would be relatively large chunks of money usually for a very capital-intensive business and for a later stage, so you are in the expansion phase. It's hard to say, how much money gets spent by family offices in an individual company startup investments. There aren't a lot of statistics on it, because it's a relatively private operation.

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But some estimates have it at on the order of several million to \$10 million in investment. Venture capital. Here, the venture capital company raises money through their own investors and they turn around and invest that money in startup companies, usually in the later stages to provide expansion capital. Generally speaking, they are going to start in the couple of million dollar range and go up to maybe, let's say, \$10 million in investment. With the typical amount invested is on the order of \$2-5 million, somewhere in there. And then finally, we have strategic partners. Strategic partners are large companies that may want to make an equity investment in a startup company, and they will do it for a variety of reasons which we will discuss in segment 4.4. So here, we are going to talk about on the order of \$1 million to \$25 plus million. With the typical investment on the order of \$10 million. That gives an overview of the rough ranges, you can see there's very, very big ranges on these, and, as you can see, more or less as you move down the list, the amounts get higher and higher, and the engagement becomes higher, and the expected stage of investment also becomes bigger in the later stages.

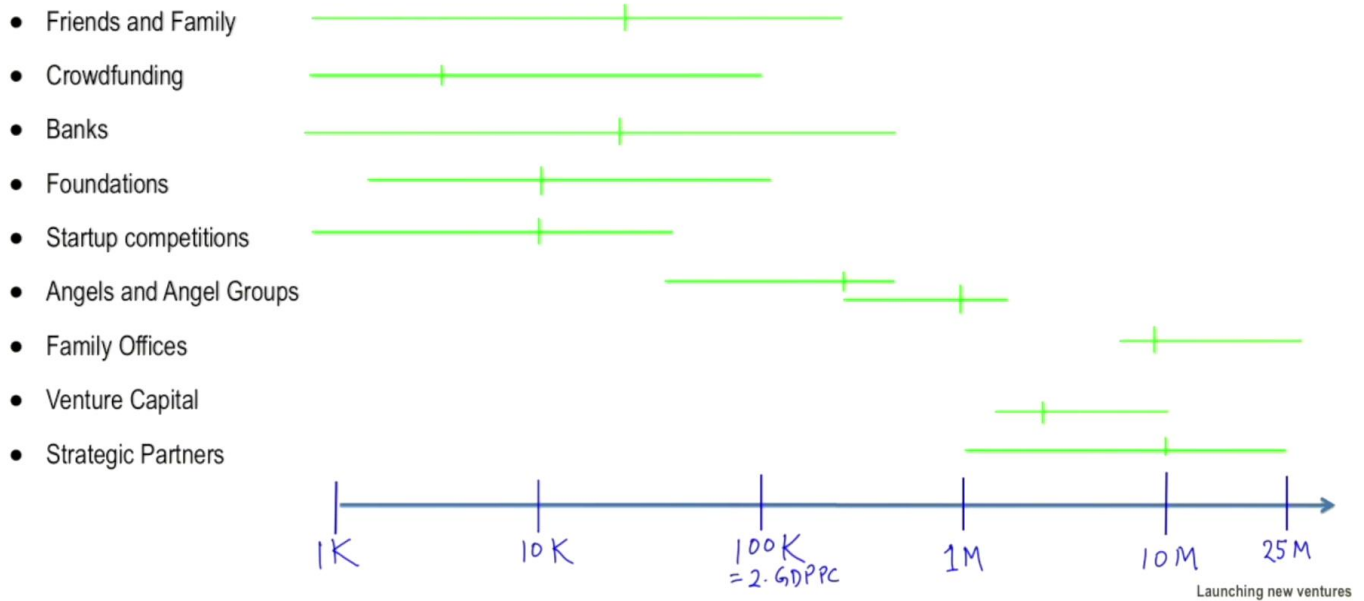
Notes

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Investors—how much to expect



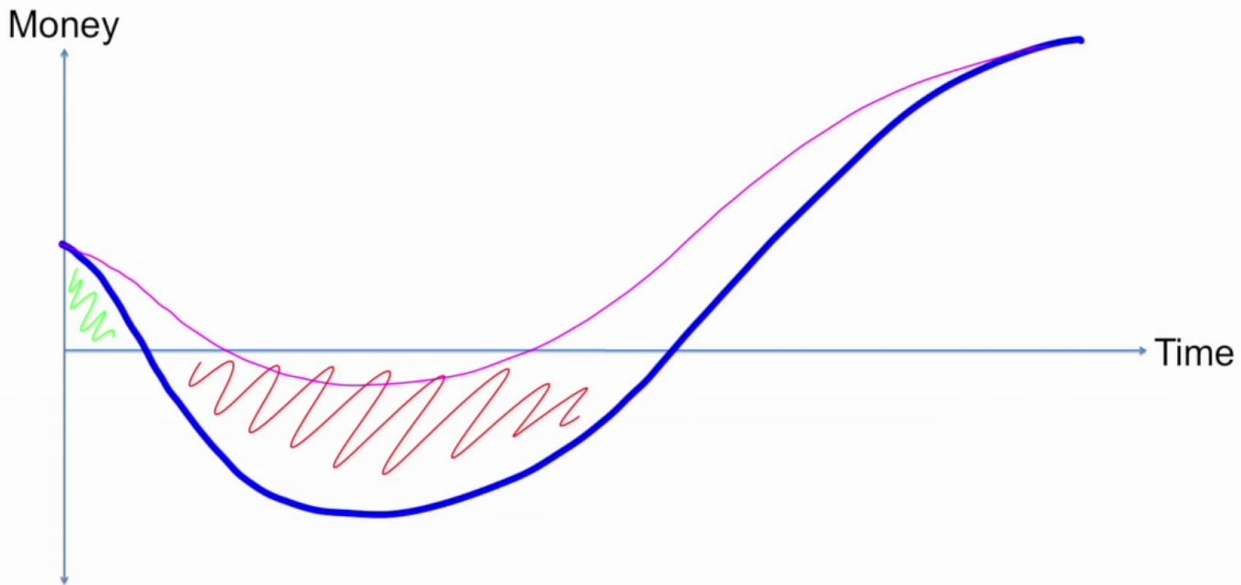
So, these ones at the bottom here are really more of the later stages investments and the ones at the top are really more of the early stage investments. And the angels and the angels groups are kind of in the middle.

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Summary



Stages of venture financing



Launching new ventures

Let's talk about sales or exit events for the founders. Usually, the founders are selling some part of their company, and the investors are having the exit event. In other words, the investor presumably gets all of their original investment back plus a return on the risk capital that they have invested. These kinds of events can happen in different ways. Some of the most common ways are trade sales, IPOs, and to some degree, management buyouts. Trade sales, as we just started talking about of strategic partnership and an investor from a strategic partner, and the big company could eventually acquire the startup company. From the startup's point of view that's called the trade sale. Sell the whole company to another company. Another option is the company can offer some percentage of their shares to the public and this is the IPO or the Initial Public Offering. This is done to raise large amounts of money in the public capital market. There are a lot of legal implications, the founders often become the minority shareholders and there is a legal framework for how to govern the company after the IPO is done, but it does have the advantage of raising a large amount of capital so that, in case there needs to be some major investments made or some big marketing expenses or other sorts of capital expenditures then, that would be a natural way to go to raise the money.

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Trade sale

- Selling the whole company to another company

Initial Public Offering (IPO)

- Selling shares to the public

Management Buyout (MBO)

- Selling the whole company to the management
- When the managers borrow money to make this transaction, it's called a Leverage Buyout

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The third way is a management buyout and this is less common in a small company, but it could be that the managers themselves, the managers, executives, founders, would turn around and buy the company back from the other investors. And you've probably heard of a *leverage buyout* and in a leverage buyout is where the managers borrow money to make this transaction.

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28m 21s

Sources of venture financing

Source	Amount	Time Frame
Family and Friends	\$1–\$250K	30 days
Crowdfunding	\$1000–\$100K	~60 days
Foundations and public organizations	\$5000–\$200K	3–6 months
Banks (loans)	\$1000–\$500K	A few weeks
Startup competitions	\$1000–\$50K	A few weeks
Angels & Angel Groups	\$250K–\$1.5M	30-60 days
Venture Capital	\$2M–\$10M	90-180 days
Strategic Partners	\$1M–\$25M	180-360 days

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This table represents a summary of the sources of venture financing with an emphasis on the more important ones that we are going to see and we are going to go into the details of these various sources in the next few segments.

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