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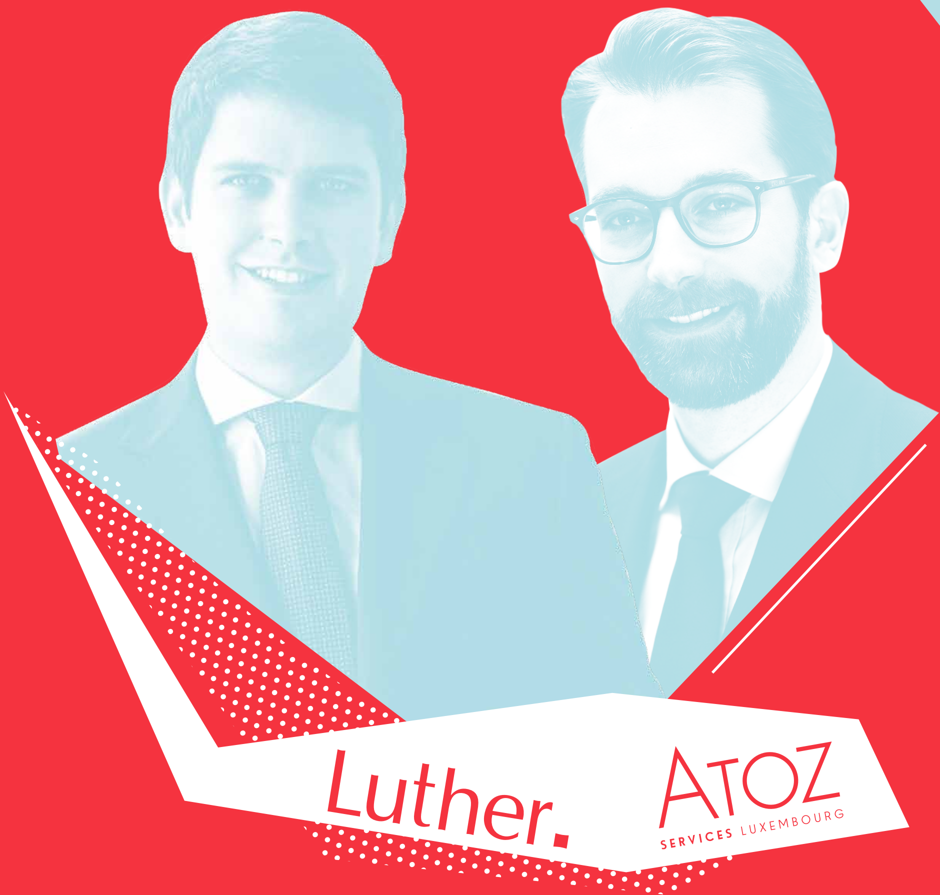
BY SILICON LUXEMBOURG



STARTUP CAPITAL RAISING

Edito

This article highlights the key elements that startup founders should consider when raising funds from investors.

Mathieu Laurent (Corporate/M&A Partner at Luther) and Christophe Darche (Partner at ATOZ Services) will share their experience in this article.

There are multiple reasons for raising funds to start or develop a business. Entrepreneurs will need the initial cash to set up their business and start their projects. Startups will then need funds to develop their technology or acquire the necessary materials to produce it, hire employees to develop their products or ensure its commercialisation, and at a later stage potentially ensure the cross-border expansion of their businesses. These reasons will of course vary from one company to another, depending, in particular, on the startup's maturity stage.

On the other hand, however, when considering raising funds, there are four fixed key elements that should be taken into account and do not vary according to the startup's maturity stage.

1 Business plan

A key milestone for startup founders should consist of preparing a sound business plan to implement their business ventures. Not only will it allow them to provide a description of their projects to potential investors, but it will also help them convert their business ideas into reality and, consequently, anticipate and solve potential difficulties in the realisation of their projects.

A basic business plan should include:

- a clear definition of the product or service which will be provided;
- a description of the target market and clientele;
- an analysis of competition and of the key differentiators their product or service will offer;
- a financial plan for the coming three to five years including proforma profit and loss accounts, balance sheets and cash flow statements, as well as the sources and uses of funds raised;
- Most importantly, it should refer to the team and its relevant experience, as it will drive the project to its success and will be a key decision factor for investors. Beyond the idea, investors invest in people;

Last but not least, as a business plan is a dynamic management tool, it should be regularly updated in light of actual performance compared to forecast performance and changes in the market environment.

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2 Properly matching the project and the targeted investors

Depending on the startup's maturity and the amount of funds to be raised, the founders will consider different types of investors: family and friends, business angels, family offices or venture capital funds.

At the very beginning of their startup projects, when it is mainly and solely an idea, the founders should raise funds primarily from:

→ FAMILY AND FRIENDS:
Generally, these investors are not only driven by the sole financial performance of their investment (as opposed to investment funds), but are also keen to support the founders to help them succeed in their entrepreneurial projects;

→ BUSINESS ANGELS:
Generally former successful executives and entrepreneurs, who are not only interested in investing their money, but also share their prior experience with the founders;

→ THE LUXEMBOURG GOVERNMENT:
It offers a series of preferential financing solutions and subsidies depending on whether certain criteria are met by the startup project.

Last but not least, the founders themselves should be the very first investors in their startup and put some "skin in the game" in the business venture they are promoting.

The funds raised by the founders from the above listed investors will be used to finance the "proof of concept" of their business ideas before presenting their projects to family offices and/or venture capital funds. Indeed, these sophisticated investment professionals analyse a multitude of projects and need to see that there is at least an operating structure in place with a committed team and an initial traction before considering any investments. Moreover, the implementation of the "proof of concept" phase will create a goodwill that will be valued in the pre-money value of the project company and will thus avoid an immediate significant dilution of the founders when family offices or venture capital funds enter the equity of the project company.

3 Equity or convertible debt funding

TWO MAIN OPTIONS ARE AVAILABLE FOR COMPANIES TO RAISE FUNDS:

The standard option is to issue new shares to investors in exchange for a cash consideration. This operation will require a valuation of the company and will have an immediate dilution effect on the equity owned by the founders (see details under point 4).

An interesting alternative for a startup is to issue convertible debt rather than issuing new shares.
To briefly summarise, investors grant a loan to the company which will be repaid, together with interest (if any), in new shares of the company at a later stage (normally at the next financing round or at an agreed longstop date). The main advantage of this alternative consists in postponing the valuation of the company until the next financing round. This practically means that by potentially increasing the valuation of the company until the next financing round, the founders reduce the dilution effect of a standard equity financing. In addition, as the documentation to be put in place for this type of financing is generally quite simple, it can take place more quickly and it is also less expensive for the company.

4 Equity financing

A standard financing from investors will take the form of an equity financing, i.e. the company will receive cash from the investors who will subscribe to new shares of the company.

Practical steps

The founders and investors will negotiate the terms of this investment. At first, they will discuss and agree on the terms of a preliminary agreement (called a term sheet) which details the key elements of the operation (as further discussed below). Once all the details of the operation are agreed, the parties will sign a shareholders' agreement which will govern their relationship and set their respective rights and obligations in the company. At last, the new shares will be issued to the investors.

Valuation of the company (pre-money valuation)

Company valuation is generally performed according to two approaches:

The external approach: It consists in identifying comparable listed companies or comparable M&A transactions involving comparable companies to the project company. The objective of this approach is to conclude on valuation multiples stating that a company comparable to the project company is valued, for instance, at X times its revenue and Y times its EBITDA.

The internal approach: Based on the founder's business plan, it consists in discounting future cash flows generated by the project company at a rate reflecting the project company's specific risk and financing structure.

The above analysis will assess a pre-money valuation of the project company which should crystallise the value created by the various stakeholders before a new investor enters the project company's equity.

In this context, timing is of the essence as the founders and their "early bird" investors will seek to maximise the created value to reduce the dilution effect without putting the project company's development at risk as a consequence of a lack of financial resources.

Dilution effect

The issuance of new shares by the company will have a dilutive effect on the existing shareholders of the company. What does this mean?

In short, the economic and political rights of the shareholders in a company are, in principle, determined by the number of shares the shareholders own in the capital of the company. The issuance of new shares to investors will thus reduce the ownership percentage of the capital of the existing shareholders.

Example: Prior to the equity financing, the share capital of the company is set at EUR 100,000 represented by 100,000 shares and is equally owned by the two founders of the company.

Scenario 1

The founders and investors agree on an equity financing of EUR 500,000 at a pre-money valuation at EUR 5,000,000.

It means that the investor will subscribe to 10,000 shares for a total consideration of EUR 500,000.

The capitalisation table of the company post-equity financing will be the following:

Shareholder	Shares	% of share capital
Founder 1	50,000	45.45%
Founder 2	50,000	45.45%
Investors	10,000	9.10%
Total	110,000	100%

Scenario 2

The founders and investors agree on an equity financing of EUR 5,000,000 at the same pre-money valuation.

It means that the investor will subscribe to 100,000 shares for a total consideration of EUR 5,000,000.

The capitalisation table of the company post-equity financing will be the following:

Shareholder	Shares	% of share capital
Founder 1	50,000	25%
Founder 2	50,000	25%
Investors	100,000	50%
Total	200,000	100%

Economic and political rights of shareholders

A shareholder of a company has, in principle, economic and political rights. In short:

→ The economic rights of a shareholder consist in a right to receive a portion of the proceeds distributed by the company (dividends, repayment of equity).

→ The voting rights of a shareholder consist in a right to vote at shareholders' meetings (appointment of directors, approval of the annual accounts, issuance of new shares, approval of a specific decision by the board of directors, etc.).

These rights are traditionally proportional to the percentage of the share capital owned by the shareholders. The shareholders' agreement and the articles of association of the company may, however, deviate from this principle by, for example, granting preferential economic rights to a specific category of shares or granting a specific shareholder with a veto right for specific decisions.

At the time of issuing new shares, it is important to understand how ordinary and extraordinary decisions of the company will be made.

In general, ordinary decisions at shareholders' meetings or board meetings are made by a simple majority vote (50% + 1 vote). Extraordinary decisions at shareholders' meetings or board meetings are made by a qualified majority (e.g. 2/3 of the votes).

It means, in practice, that further to the issuance of the new shares, the founders may need the consent of the investor for extraordinary or even ordinary decisions. This will depend on the share capital allocation among the shareholders and the terms of the shareholders' agreement and the articles of association of the company.

By way of example, in the above-mentioned scenario 2, the consent of the investor will be necessary for extraordinary and ordinary decisions of the company. Unless the parties agree to grant specific rights to the investor, this will not be the case in scenario 1.

At the time of raising funds, the founders will have to consider the level of control they intend to maintain on the company.

In addition to these economic and political rights, the shareholders will traditionally agree on specific rights and obligations, such as the right to appoint directors, the determination of the annual business plan, transfer restrictions on shares, non-compete provisions, etc.

Investors and board composition

Depending on the type of investors attracted by the startup and also the size of their investments, investors may be interested or even request one or several seats at the board of directors of the company in order to supervise or even control the strategic management of the company.

The investors' involvement in the management of the company can be of a strategic advantage since they can bring additional experience, knowledge and visibility to the founders and the startup.

Incentive plan for key employees

As part of its development, a startup will need to attract talented persons who will assist the founders in developing the technology or the services provided. These talented persons will generally accept to receive a lower salary than they could expect from a more mature company but on the condition that they are associated with the startup's success.

The standard tool to incentivise these talented persons is commonly known as "stock options". Stock option plans can take different forms but the rationale remains the same: employees will receive or have the right to subscribe to shares in the company at a discounted price or even for nil consideration. In the case of an exit (see below), employees will receive shares or a cash consideration in line with the market value of their shares.

As part of the fundraising process, it is rather standard to agree on a percentage of the share capital of the company (10% or even more in practice) which will be reserved for or allocated to the employees' incentive plan. This element has to be taken into account at the time of negotiating the valuation of the company.

Remuneration

At the time of raising funds, it is important to bear in mind that the founders will generally commit to dedicating most or all of their time to the project and that, in practice, the company will not distribute dividends in the near future. The founders will likely need to receive a salary and it is therefore standard to agree on the remuneration to be paid by the company to the founders in the coming years.

Follow on investments

A startup will in practice often conduct several rounds of financing, each series of financing being designated by a letter and starting with the Series A round. It is not uncommon to see startups conduct a Series F round before completing an exit.

Bearing this in mind, it is good practice to provide incentive mechanisms for the existing investors to continue investing in the company over the years (e.g. pay-to-play provisions) or at least keep sufficient flexibility to raise additional financing, if the existing investors do not want to continue investing.

Another sensitive matter in this respect is the dilution protection mechanism in favour of the investors. In short, these mechanisms will protect the previous investors in a down-round (i.e. when the price per share in a round of financing is lower than the price per share in a prior round) by increasing their rights. These provisions have to be understood and monitored by the founders since, on top of their dilutive effect on their participation, they may hinder the next financing round.

Exit

Investors generally invest in a company for a defined period of time with a view to make a profit. Startups will, in principle, not distribute dividends to their shareholders. The most common exit strategies (also known as liquidation events) are a sale of the company or its assets. For more mature companies, a listing on a stock exchange can also take place.

In this respect, it is important to understand two concepts:
(i) the liquidation preference right and
(ii) drag along provisions.

A liquidation preference right is traditionally associated to preferred shares subscribed by investors.

This is first a protection mechanism for the investors. In short, it means that the preferred shares will benefit from a priority right to receive distributions generally up to the subscription price paid for these shares.

This mechanism will have an important impact on the distribution of the proceeds at the time of the sale of the company and, in particular, if the company is sold for less than the amount of capital invested.

As an example, in a scenario of a company having raised 5 million euros from investors (see prior example 2) and sold a couple of years later for 4 million euros: if the investors have a strong liquidation preference protection, it means that the other shareholders (traditionally the founders) will not receive any consideration from the sale of the company.

On top of this protection, the preferred shares may also include a conversion mechanism into ordinary shares under specific conditions (e.g. X preferred shares convert into Y ordinary shares) or a specific right to participate in the distribution of proceeds related to a liquidation event (e.g. once the amount invested is fully returned to the investors, the ordinary shares and the preferred shares equally share any remaining proceeds). In short, these features constitute the economic rights of the investors in case of an exit and have to be understood by the founders since one preferred share may be significantly worth more than one ordinary share from an economic perspective.

Drag along provisions are important features to understand and monitor. These provisions will traditionally authorise a majority investor or a group of majority investors to force the sale of the whole capital of the company (i.e. including the founders) to a third party buyer. These provisions are market practice and can hardly be rejected, but the conditions of their exercise (in particular concerning the price) should be carefully monitored in order to ensure that all the shareholders will in some way benefit from the operation.

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