Equity Financing for Entrepreneurs

Entrepreneurship: The Practice and the Mindset by Heidi M. Neck, Christopher P. Neck and Emma L. Murray

Learning Objectives

• Define equity financing for entrepreneurs and outline its main stages.
• Illustrate the basics of enterprise valuation.
• Describe angel investors and how they finance entrepreneurs.
• Explain the role of venture capitalists and how they finance entrepreneurs.
• Describe how investors carry out due diligence processes.
• Explain the money vs. power trade-off and the funding life cycle.

Notable Quote

• “There are two times for a young company to raise money: when there is lots of hope, or lots of results, but never in between.”
• -George Doriot, American Venture Capitalist

What is Equity Financing?

• Equity financing: The sale of shares of stock in exchange for cash. (Splitting the ownership pie)

Stages of Equity Financing

• Seed stage financing
• Start up financing
• Early-stage financing

Notes:
There are several stages of investment, but for the purposes of this chapter we focus on the initial stages of equity financing usually provided to young companies: seed stage financing, startup financing, and early stage financing. Seed stage financing usually consists of small or modest amounts of capital provided to entrepreneurs to prove a concept. Startup financing is the money provided to entrepreneurs to enable them to implement their idea by funding product research and development; and early-stage financing consists of larger amounts of funds provided for companies that have a team in place and a product or service tested or piloted, but as yet show little or no revenue. Contap Inc., as explained in the Entrepreneurship in Action feature, is a good example of an early-stage
company which managed to acquire $250,000 in investment funding before the app had generated any revenue.

One of the most important factors to consider when you are thinking about seeking investment is to find investors that are most suitable for your stage of the company. Timing is also a factor. There is no use in a venture looking to raise funds when it is down to its last dollar. For one thing, it can take at least six months to raise money; in addition, a desperate early venture may give away far too much equity than it should to investors, which can seriously dilute the position of its founders.

As the business grows and starts to take in more revenue, entrepreneurs may seek second-stage or later-stage financing. Even further down the road, a profitable company looking to expand and go public through an initial public offering (IPO) may seek investment through the third or mezzanine stage of financing. Finally, entrepreneurs may need bridge financing to cover the expenses associated with the IPO. These stages are displayed graphically in Figure 13.1.


**Stages of Equity Financing**

- Figure 13:1 Stages of Equity Financing

![Graph showing stages of equity financing](https://www.marsdd.com/mars-library/angel-investors-seed-or-venture-capital-investors-that-depends-on-your-stage-of-company-development/)
Forms of Equity Financing

- Angel investors: Informal investors that provide money for startups.
- Venture capitalists: Professional investors that generally invest in companies because of perceived long-term growth potential.

Notes:

Differences Between Angels and Venture Capitalists

- **ANGELS:**
  - Individuals worth more than $1 million
  - Invest $25- $100 personal funds
  - Fund seed or early-stage companies
  - Carry out informal due diligence
  - Responsible for own decisions
  - Exit with returns on personal investment

Notes:

Differences Between Angels and Venture Capitalists

- **VENTURE CAPITALISTS:**
  - Limited partnership
  - Invest from $500,000 and up in VC funding
  - Fund from early to late stage companies
  - Conduct formal due diligence
  - Decisions made with committee
  - Exit with returns to fund’s partners
Basic Valuation Factors

Notes:
The answers to the key questions will help investors determine an approximate value for your business before giving you an idea of how much they are willing to invest. This is why it is important to do your own homework in order to prove that your business is worth investing in. By providing an estimated valuation of your business before you meet with investors, you can display business savvy and commitment to growth.

Angel Investors

- After friends and family, angel investors support up to 90% of equity raised by startups.
- Angels invested $24.8 Billion in startups in 2013 (estimate).
- Angels funded almost 71,000 in early-stage ventures in 2013.
- Angel-invested early companies (less than 5 years old) over a 25-year period accounted for all of the net new jobs in the US.
- Economic research shows that the largest growth comes from innovative (angel) startups.
- Angels provide mentoring, monitoring, and guidance.
- Angels provide connections and introductions to their widespread network.
- Angels teach entrepreneurs valuable business strategies.

Notes:

Types of Angel Investors

- Entrepreneurial angels
- Corporate angels
- Professional angels
• Enthusiast angels
• Micromanagement angels

Notes:
In recent years angel investors have begun to form into groups in order to share their knowledge and collaborate to find startups to invest in. Table 13.4 illustrates the top 10 angel groups in the US and the startups they have funded. These angel groups are spread all over the country and tend to specialize in specific areas. For example, Golden Seeds focuses solely on women-led startups, while Tech Coast Angels looks for technology startups in particular.

**Venture Capitalists**

• Often former or current entrepreneurs
• Usually professional money managers
• Seeking opportunities likely to return 10 times their investment in five years.
• Mainly invest in high-technology companies
• Usually invest in later stages

Notes:

**Venture Capitalists**

Notes:
Like angel investors, VCs are often former or current entrepreneurs but, unlike angels, they are mostly professional money managers. Like angel investors, VCs look for opportunities that are likely to return 10 times their investment in five years.

**How to Find the Right VC**

• Find investors who can provide the amount of capital you need.
• Check whether they are interested in investing in your company’s current stage of growth.
• Ensure they are experts in the industry you are working in and have a good track record of experience growing companies.
How to Find the Right VC

- 4. Look for VCs that can provide advice, contacts, moral support, etc.
- 5. Make sure they have the time and commitment to support your venture.
- 6. Make sure they have a good reputation.
- 7. Check their history of building new companies.

Notes:
When you as an entrepreneur get the opportunity to meet with a VC, it is important to be prepared. You will be expected to explain clearly and concisely the market opportunity your business presents; the size and potential growth of your market; why customers will be attracted to your product/service; how your business makes money, or will make money in the future; how soon it is anticipated to reach profit; why you and your team are the right people for the job; and how your investor can exit the investment. By providing this information to the VC, you are displaying your confidence, knowledge, and commitment in your business as well as reassuring the VC that you are in it for the long haul.


Critical Thinking Questions

- Why do you think VCs tend to “bury their dead quietly”?
- 2. Do you think it’s important to learn about failures as well as successes? Why or why not?

Due Diligence Process for Angels

- Founders
- Legal
- Market
- Finance
- People
- Exit strategy

Critical Thinking Question

- You’re in a meeting with an angel investor whose funding could jump-start your venture. How would you feel if you had to answer the investor’s questions with “I don’t know” several times in a row?
Entrepreneur’s Dilemma

Notes:
The typical “entrepreneur’s dilemma” is choosing between retaining significant ownership and control versus securing substantial funding. The venture typically starts with finding partners and securing initial funding, followed by formal founding and registration of the business. As the business grows and additional financing is needed, angel and venture capital investments are sought out. Finally, the most successful of startups often accomplish an IPO.

The Trade-Off Entrepreneurs Make

Notes:
Being pushed out or moved to a “lesser” position can come as a real shock to entrepreneurs who have worked tirelessly on building their ventures from the ground up, as well as to employees who have worked alongside them. In fact, the way this leadership transition is handled by both the investor and the entrepreneur can make or break a company.
One of the most common mistakes founders make is believing they can grow the business through inspiration, passion, and perspiration. While these three key elements are helpful in getting a business off the ground, entrepreneurs need better resources to fully capitalize on future opportunities. As a company evolves, it needs different skills to grow into a more valuable business.

Hypothetical Startup

- Finding a co-founder
- Finding early funding
- Registering the company
- Finding an angel
- Cutting the pie
- Seeking venture capital
- Going public

Critical Thinking Question

- What would you do if you realized you had unintentionally provided critical but inaccurate information to an angel investor?
How Startup Funding Works

- Figure 13.6: How startup funding works