Raising Capital for your Startup Venture

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4thly.com

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Introduction

You've picked a great time to think about raising capital for your startup. There are more sources and structures of startup capital available in 2022 than at any other time in history.

The money is flowing freely right now. According to Crunchbase there was $643 billion in venture capital deployed in 2021, up from $335 billion the previous year and 2022 is projected to be even bigger. Those are crazy numbers.

But for new startup entrepreneurs, how do you find the right sources? How do you compare the various structures and avoid pitfalls?

This booklet is designed to serve as a guide to help you finance your startup venture. I'll cover some basic concepts to understand, introduce you to the wide range of sources available, and give you some things to think about as you consider which kind of financing is best for your particular startup.

This booklet is not a substitute for having a good attorney or other professional to advise you. But hopefully it will be a helpful as you consider all the different ways to finance your startup venture in 2022!

>$643 billion

in venture capital deployed in 2021

more in

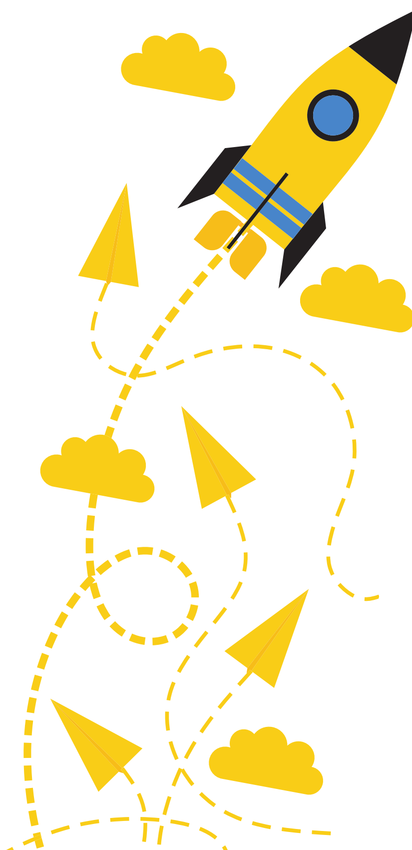
2022

The many sources of capital for startups today

When most people think startup financing they immediately think Venture Capital. But before we get to the mechanics of how the VC business works, I want to talk about all the **other great ways** to finance your startup.

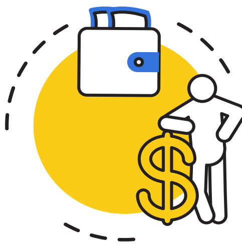
The fact is that 99% of the successful businesses in the world have never raised a single penny of venture capital. So I want to start by expanding the solution set in your mind a bit – we'll review venture capital financing, but first let's look at the wide range of other financing options available to entrepreneurs in 2022.

Here's a rundown on the many different sources and structures you could consider for financing your awesome new startup:



Bootstrap it, baby

The absolute best way to finance a startup, of course, is to simply grow it out of profits. This is the way most businesses have been built. Want a Silicon Valley example? Farmgirl Flowers was created entirely from the founder's own savings account, she's grown the company strictly organically (pun intended), and she now has a company doing more than $50 million a year. And she still owns 100% of the company. Want another example? MailChimp is a billion dollar company that has never raised any outside capital. There are many other examples (see my post on this topic). Bootstrapping remains the best way for any entrepreneur to build a company, if you can.



Rich Uncle Bob

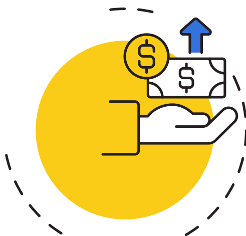
Many entrepreneurs have gotten their venture off the ground with friends and family money. Borrowing from relatives has its pros and cons, of course (if you lose your mother-in-law's money she'll never let you forget it), but if there is someone in your family who has the capacity to help, and believes in you, this is a very common way to raise initial funding for your startup. **Structure**: *Can be anything you agree upon. A convertible note (which converts at the holder's option) can be a family-friendly structure.*

Bank Loan

Walk down to your friendly bank and ask the manager for a loan to get your startup off the ground. You'll get a reasonable interest rate, and you won't give away any equity in your startup! The downside is that you will almost certainly need to personally guarantee the loan (eg: pledging your house) which can be a difficult conversation with your spouse. The amount you can borrow may be limited by your credit and personal assets (see my post on debt vs equity) **Structure**: *Typically either fixed-term or revolving debt.*

Venture Capital

Take a stroll down Sand Hill Road, hoping to show someone your pretty pitch deck! The purpose of venture capital is to allow companies to grow at an unnatural velocity, in return for a large chunk of equity. Outcomes with a venture-financed business tend to be binary — home run or a strike out (eg, IPO or bankruptcy). It's like airplane travel — you either arrive safely or you die (except the odds with airplane travel are much better). This model is a great fit for some high-growth startups (Google, Uber) but less good for ordinary businesses. The other key thing to know about traditional venture capital is that the partners aren't investing their own money — they are investing the money of the Limited Partners who put money into the fund (typically large institutional investors). This fiduciary relationship often limits their flexibility in investment decisions. **Structure:** *Preferred equity.*



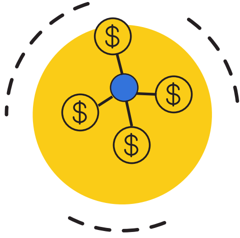
Angel Investors

While VC investors are investing from funds of other people's money, Angel Investors are individuals investing their own money. This gives them the ability to make "gut level" investment decisions (which early-stage investing usually is), and more flexibility. Introductions to angel investors almost always happen through personal social connections. **Structure:** *Typically either Convertible Notes or SAFE's (both of which end up eventually as preferred equity).*

Corporate Venture Capital (CVC)

Many large corporations have a venture capital fund for investing in startups that are aligned with their strategic interests. So if you are an innovative food production startup, for example, look up the 10 largest food production companies. Chances are most of them have a corporate venture capital fund. Pitch them on how an investment in your company can serve their strategic mission.

Crowdfunding



Sites such as Kickstarter and Indiegogo primarily focus on creative projects (music, film, technology, art, design, etc) not startup businesses, per se, because selling debt or equity gets into highly-regulated territory. But pre-sales of products on these platforms can be a great way to launch a startup. Many entrepreneurs have built a prototype of a product and then launched a Kickstarter campaign seeking pre-purchasers of the product (this is how Peloton got started). If you get 10,000 people to each pledge to pre-purchase your product for $100 — boom! — you've raised a million dollars and also proven market demand for your product! Meanwhile, sites such as AngelList can connect you with angel investors, and sites such as NextSeed and Republic provide platforms for entrepreneur fundraising. **Structure**: *Wide range. Can be funding structured as Term Notes, Revenue Sharing Notes, or Preferred Equity.*

Equity-based Startup Accelerators

The most famous startup accelerator is Y-Combinator, which offers $125,000 in cash in return for 7% equity in your startup. There are many of other types of startup accelerators now, including several that are sector-specific. Alchemist is exclusively for enterprise-focused startups, and Miller Center is exclusively for social entrepreneurs. Be aware that getting capital this way can be expensive: Y-Combinator's $125K for 7% of your company is a relatively steep price given today's valuations. **Structure:** *A very wide range, including SAFE, an investment structure which was developed by Y-Combinator.*

Revenue-share financing

On platforms such as NextSeed you will find financing deals structured such that the startup pays a percentage of revenue to the investor, capped at a certain level. I recently participated in one, as an investor, where I'll be paid 5% of the revenue of the company until I've received 1.5x my investment, and then the agreement terminates. I've seen similar deals that are royalty-based — for example the investor gets $1 for every product sold, up to a cap. This is an excellent structure that aligns the interests of the investor with the interests of the company (especially when an IPO or large M&A transaction is not a likely investor exit).

Credit Cards

Don't do it. There is mythology about entrepreneurs who have launched a business by maxing out their credit cards and then going on to be billionaires. It's pure mythology. This approach will yield a 99.9% failure rate. Don't do it.

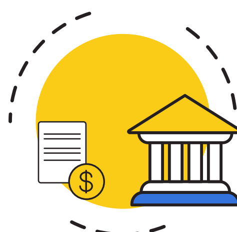
Customer Financing

Find a customer who wants your product so much they'll help finance your startup! Many enterprise software startups have financed themselves by finding a corporate customer to pay for a custom-developed software implementation (which the startup then retains rights to productize and sell to others). In the defense industry, many startups have built an early prototype and then convinced the Department of Defense to provide the funding to develop it further. This will look different for different sectors, of course, but customer financing is a tried-and-true way to launch and grow a startup.

Vendor Financing

I once started a business which needed some expensive capital equipment in order to get off the ground. I was stuck on how I was going to finance that until I met with the equipment vendors and realized they would finance it for me, in order to get a new customer. It dramatically reduced my startup capital needs.

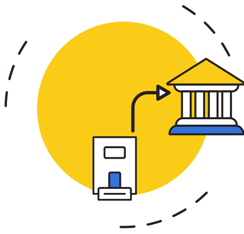
Venture Debt



Almost all venture capital is structured as equity. But there is a category called "venture debt", offered by certain banks and speciality finance firms. It is typically used alongside a venture capital equity round, with the venture debt component used to purchase capital equipment, for example. Silicon Valley Bank has been a leader in this field. **Structure:** *Like a bank loan but with stock warrants added in to compensate the lender for the higher risk.*

Impact Funds

Are you starting up a social enterprise that will save the world? Great news — there are funds to pitch for that! Until a few years ago, social enterprises were difficult to finance — they weren't "non-profit enough" for grant capital from foundations and they were "for-profit enough" for venture capital. But a whole new asset class has appeared, called Impact Capital. This typically comes from impact funds that have been put together partly to have a social impact in a particular sector, and partly to provide an economic return on capital. Examples include New Schools Venture Fund (for startups working in the education sector) and Acumen Fund (focused on global poverty).



SBA Loans

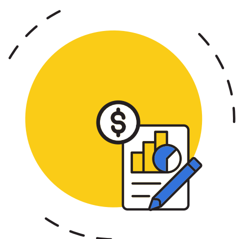
The US Small Business Administration can help you finance your business. They don't make the loans themselves, instead they guarantee loans that you get from a bank. The idea is that banks can make startup loans that are riskier than they would normally issue, and the SBA is helping US businesses to grow, succeed, and create jobs. Use their Lender Match tool to find SBA-approved lenders. Also, depending on your field, SBIR grants ("American's Seed Fund") may be available.

Non-bank Business Lenders

Traditional banks are highly-regulated, so they tend to not have much flexibility in their credit underwriting. Meanwhile, there are some new sources of business loans including Kabbage, which is a non-bank lender that uses a variety of factors (including social media activity) in their credit decisions. Also, sites such as Fundera allow you to fill out one loan application and then they shop the deal around to a variety of business funding sources. Finally, peer-to-peer marketplaces such as LendingClub offer business loans up to $500K from non-bank sources.

Alternative Growth Capital

There is a growing awareness that neither traditional venture capital nor traditional bank lending is well-suited to many online businesses today. A relatively new entrant, ClearCo, addresses this with revenue-share financing specifically to fund the growth of businesses that have a positive CAC (Customer Acquisition Cost) to LTV (Lifetime Value of a customer) ratio. They deploy up to $10 million in capital to a company, in return for a revenue share that is capped at capital infused plus six percent. For SAAS subscription-based startups, Pipe offers non-dilutive finacing.



Other alternative structures

There is a great deal of innovation going on today in financing vehicles, especially for social ventures and other startups that don't fit traditional molds. Miller Center has developed the Variable Payment Obligation (VPO), where the repayment obligation is better-aligned with a startup's cash curve. There are also structured exit financings, that allow investors to get future liquidity on companies that are unlikely to have a traditional exit (M&A or IPO). The idea behind all of these is to get better alignment of incentives between investors and entrepreneurs across a wider range of venture types.

Specialty Funds

We've recently seen the emergence of very narrowly-focused venture funds, such as Chris Sacca's new Lowercarbon Capital which invests in startups which reduce carbon emissions and Spero Ventures which focuses on wellbeing and sustainability. There are many other examples. Google is your friend.

Summary

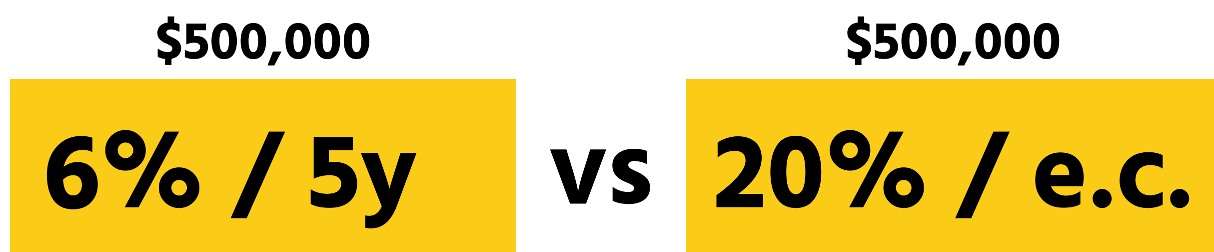
Obtaining capital is like obtaining anything else for your business — you can buy it, you can rent it, or you can rent-to-own. And you can get it from a bunch of different suppliers. So let go of the thought that the only way to launch your business is to meet a venture capitalist. Just start building a great business, choosing smart financing at each step.

A look at debt vs equity

Your parents probably told you that debt is evil. And they aren't wrong. But when it comes to choosing debt financing vs equity financing, many entrepreneurs think of debt as inherently onerous and equity financing as inherently better. But that's not actually accurate, in terms of true economic cost. As any first-year MBA student who has been forced to do a WACC calculation knows, **debt capital is generally much less expensive than equity capital.**

First, some quick definitions: **A debt holder** is entitled to receive principal plus interest, paid back over some amount of time. They have no claim to equity in the company, no claim to future profits, and no claim to any future liquidity beyond the principal plus interest. An **equity holder** is pretty much the opposite: They are not entitled to repayment of the principal, but they **do** have a claim to a share of all future profits in the company, and a share of any future liquidity (M&A or IPO).

Let's take a look at a hypothetical example: Say you had one source of capital offering you $500,000 in debt financing, at 6%, amortized over five years. And you have another source of capital whispering in your ear saying "*Don't take that — I'll give you the same $500,000, but I'll structure it as 20% of the equity in your company. No payments required!*"



Before you choose which one sounds better, let's look at the math: The debt capital will cost you $79,984, spread over 5 years (and that interest is fully tax deductible for the company, to the extent it offsets earnings). If you think $80K is more expensive than 20% of all the future profits and equity upside in the company, then I have some pretty serious concerns about your expectations for the venture.

The problem, of course, is that most startups don't have the creditworthiness to get the loan, nor do they have the cash flow to service the debt. That's why the venture capital industry was created: to make a ton of money doing equity financings for companies that can't qualify for debt financings.

The good news, of course, is that we no longer live in a binary world where the choice is just debt or equity. Most startups will end up with a combination of the two, and many startups do their first financing as convertible notes which begin as debt and then convert to equity in the future (see glossary).

You may still end up doing a traditional equity financing for your startup, but don't fool yourself into thinking it's a better economic deal than debt financing; it's probably not.

How the Venture Capital Business Works

Some people think a venture capitalist is just a crazy rich guy who likes writing checks to entrepreneurs. It's a little more complicated than that. I want to give a quick overview here of how their business works.

Venture Capital firms are actually managing other people's money, much like a mutual fund. The partners decide to raise a fund, they go out and pitch individuals and organizations on putting money into that fund, the fund is invested in awesome startups, and after ten years the fund is dissolved and 80 percent of the profits are paid out those who put money into the fund while 20% of the profits go to the partners who managed the fund.

This is called the "2 and 20" system — 2% of the capital in the fund is the management fee that goes to pay the operating expenses (salaries and rent on Sand Hill Road), plus the General Partners also get 20% of the profits at the end of the fund life. The rest of the money gets distributed to everyone who put

money into the fund (called Limited Partners).

Most of the investors in venture funds are pension plans, university endowments, and other large institutional investors plus a few high net worth families.

So you and I could start a venture fund of our own. We tell everyone that we're really good at picking successful startups, and if they want to put money into our awesome fund we'll just simply charge them a 2% management fee plus 20% of the profits from the fund. What could go wrong?

Venture Capital is actually a very difficult business. Most VC firms fail to provide their investors with expected returns. According to PitchBook, the vast majority of the asset class's returns come from just a few top venture firms. So you and I starting a new fund wouldn't really be that likely to succeed (sorry).

It is a business that historically has been about high risk/high return investments with binary outcomes: each investment ends up either bankrupt or worth billions. Historically, about 75% of their investments fail, but the other 25% succeed wildly and make the whole fund a success.

What all this means to you:

As with anything else, you'll always do better negotiating with someone if you understand their world. In that context, here are some things to keep in mind:

- Because they're not investing their own money, they have a fiduciary responsibility to their investors (called Limited Partners). This is a key concept to understand (Angel Investors, on the other hand, are investing their own money and so have a wider latitude in their investment decisions).
- If you're looking for a little bit of money to create a nice little business, it's just not a fit for traditional venture capital. Their model depends on making big bets and creating billion dollar unicorns.
- A fund life is typically 10 years, and a venture firm typically has several different funds under management at any given time. The first 2–3 years

of a fund is spent making investments, the next 3–4 is sitting on boards and managing those investments, and the final 2–3 is trying to get liquidity on those investments by selling the company or getting it to have an IPO. So you should always ask which fund they might be investing from, and what the current lifecycle stage is for that fund.

Just tell me how to meet one!

In my years of teaching entrepreneurship, I have often been asked "How do I meet a venture capitalist?". I raised a fair amount of money in my career, and I think every investor I've ever had is someone I met socially or was introduced to me by someone I knew socially. So there's your answer. It is extremely difficult to "cold call" your way into a venture firm because the good ones stay very busy looking at investment opportunities that were introduced to them by people in their network who they know and trust. Nurture your personal network.

And now a word about diversity:

Historically, general partners at venture capital firms were middle-aged straight white guys with MBA's from a top-ten business school. Their view of success was people who looked like them - implicit bias in action. That is changing, and not just because of social pressure — there's plenty of evidence today that picking only straight white guys isn't a very good investment strategy. So we're seeing a pretty dramatic recomposition of the general partners of venture capital firms. There are more women and more people of color making investment decisions than ever before. That doesn't mean the playing is level yet, but it does mean that we're moving in the right direction.

Anatomy of a Term Sheet

CONFIDENTIAL

BREAKFUST, INC

MEMORANDUM OF TERMS

This Memorandum of Terms represents only the current thinking of the parties with respect to certain of the major issues relating to the proposed private offering and does not constitute a legally binding agreement. This Memorandum of Terms does not constitute an offer to sell or a solicitation of an offer to buy securities in any state where the offer or sale is not permitted.

THE OFFERING

Issuer:	Breakfust, Inc., a Delaware corporation (the "***Company***")
Securities:	Series A Preferred Stock (the "***Series A Preferred***")
Valuation of the Company:	$5,000,000 pre-money
Amount of the offering:	Up to $3,500,000
Consideration:	Cash
Number of securities:	3,500,000 shares
Price per share:	$1.00
Investors:	Raviga Ventures or affiliated entities, and other investors acceptable to the Company.
Anticipated closing date:	Initial closing on or before May 1, 2021, with one or more additional closings within 60 days thereafter.

TERMS OF THE PREFERRED

Dividends:	*Dividend rate:* 8%
	Cumulation: Noncumulative
	Priority: Senior to common.
	Participation: Common may not receive any dividends unless Series A Preferred receives a dividend (including the preference amount) equal to the amount it would have received if converted to common.
Liquidation preference:	*Amount:* Original purchase price plus accrued dividends.
	Priority: Senior to common.

This example is for a Series A (first equity financing) for a startup.

For many entrepreneurs, getting a term sheet from an investor is the moment they've been waiting for. A term sheet is simply a non-binding document outlining the terms of a proposed investment. If accepted, it then becomes a guide for the lawyers who will draw-up the actual legal documents required to complete the financing. As with anything, all of these terms are negotiable. So let's dive in and understand what they mean.

Here are line items on the term sheet, followed by (in *italics*) an explanation of each:

Issuer: Breakfust, Inc, a Delaware corporation (the "**Company**")

This is your startup, issuing stock which will be purchased by the investor(s).

Securities: Series A Preferred Stock (the "**Series A Preferred**")

Typically the first equity financing of a company is called "Series A", the next round is called "Series B", etc. It simply refers to a series of stock certificates issued with each financing. Lawyers aren't very imaginative so they just call each series of stock certificates "A, B, C", etc.

Valuation of the Company: $5,000,000 pre-money

In order to calculate what percentage of the company the new investors will own, we need to agree on a current value of the company, before the financing (called the "Pre Money Valuation"). You want this number to be high (which gives the investors a smaller share of ownership for their money) whereas they want it to be low. After some back-and-forth, you'll hopefully agree on a number.

Amount of the offering: Up to $3,500,000

Number of securities: 3,500,000 shares

Price per share: $1.00

I've kept the math simple for the sake of this example. The actual numbers will be computed based on the current cap table for your company, how many new shares will need to be issued, etc. In this example, with a Pre-money valuation of $5M, and investors putting in $3.5M worth of new money, this means the Post-money valuation of the company will be $8.5M and the new investors will own 41% of the company ($3.5M divided by $8.5M).

Dividends: Dividend rate: 8%

This means that the investors will be "paid" a dividend each year on their stock. Typically they don't actually expect to be paid in cash, but they do expect these unpaid dividends to accrue (and they'll get them at some future liquidation date).

Liquidation preference: Amount: Original purchase price plus accrued dividends.

This means that when the company is liquidated, either by being sold or by being wound-down, they will get their investment back (plus accrued dividends) before any money goes to any founders or employees.

This is an extremely important provision for you to understand.

Conversion: The Series A Preferred may be converted at any time, at the option of the holder, into shares of common stock. The conversion rate will initially be 1:1, subject to anti-dilution and other customary adjustments.

Automatic conversion: Each share of preferred stock will automatically convert into common stock, at the then applicable conversion rate, upon (i) the closing of a firmly underwritten public offering of common stock (a "**Qualified Public Offering**"), or (ii) the consent of the holders of a majority of the then outstanding shares of the preferred stock.

Investors want to hold preferred stock (and get the benefits of that) until the IPO, at which time they want to convert to common stock so that they can sell them on the open market. These provisions deal with that.

Anti-dilution: Adjustments. The conversion price of the Series A Preferred will be subject to adjustment, on a broad-based weighted-average basis, if the Company issues additional securities at a price per share less than the then applicable conversion price.

The investors want to avoid getting unfairly diluted if there's a future financing at a lower valuation (a "down round"). This provision protects them in that scenario.

Voting for directors: The holders of Series A Preferred will be entitled to elect two directors. The holders of common stock will be entitled to elect three directors. Any additional directors will be elected by the holders of preferred stock and common stock voting together.

This defines the initial Board of Directors as having two seats chosen by the investors and three seats chosen by the founders. This should map closely to the percentage of stock owned. In this example, the investors will hold 41% of the company and have 40% of the board seats.

Information rights: Each holder of at least 10,000 shares of Series A Preferred will have full information rights.

This sets a threshold as to who can call you up anytime and ask for financial statements and other information.

Proprietary information agreements: The Company will have all employees and consultants enter into proprietary information and inventions agreements.

Very standard. They want to make sure that all the IP created belongs to the company, not the founders and employees.

Purchase agreement: The investment will be made pursuant to a stock purchase agreement which will contain, among other things, appropriate representations and warranties of the Company and the investors and appropriate conditions of closing.

There will be a very long legal document prepared by the lawyers where you represent that you've disclosed everything you know, there is no pending litigation you haven't told them about, etc, etc, etc.

Legal fees and expenses: The Company will pay the reasonable fees and expenses of counsel to the investors if the financing closes.

That's right! You get to pay your lawyer ***and*** *their lawyer for handling the transaction! This may seem bizarre, but it is considered standard. The rationale is that the venture fund wants the transaction costs to come from the fund, not from their management fee.*

Conditions precedent: The investment will be subject to customary conditions, including but not limited to completion of due diligence to the satisfaction of the investors.

This means that deal won't close (and funding won't happen) until and unless they complete due diligence to their satisfaction on everything about the company. Every skeleton you have in the closet will come out, so be prepared for that.

Those are the typical items you will find on a standard term sheet for a Series A venture capital financing. You will want to review with an actual lawyer before you sign anything. Remember that everything is negotiable!

Pitch Decks

To meet with investors, you'll probably want to have a "Pitch Deck" - a set of slides that gives an overview of your startup venture and the investment opportunity.

Some people think there's magic in creating a "winning" slide deck, but remember that venture capitalists don't invest in pitch decks; they invest in people. And people who are great entrepreneurs have the ability to tell a crisp, clear, and compelling story about what they working on, and **why it matters**.

One of the most valuable lessons I learned as an entrepreneur happened when I took my carefully-prepared pitch deck into a meeting with a venture capitalist opened up my laptop, got ready to show him my awesome slides, and he said

"Close that damn thing up. I don't want to see your stupid slides. What I want to know is whether you can tell me using words — and words alone—why what you're working on is so interesting that I would want to invest".

I did, and he invested, but he never saw those beautiful slides I had worked so hard on.

So my first piece of advice, with regard to slide decks, is to first make sure that you have a crisp, clear, and compelling story to tell. Once you have that, creating a few slides to provide visuals for the story should be easy. Creating the compelling story (and making it short) is the hard part.

The things that go into your story might include:

- Why are you the exactly the right entrepreneur for this venture?
- What problem are you solving?
- What's your secret sauce?
- How will your venture make money?
- What does the current competitive landscape look like?
- How big is the opportunity?
- How are you going to efficiently acquire customers?
- What are your initial capital needs, and what milestone will that initial capital get you to?

This is not a definitive list, of course. Every venture is different. But you should be able to, in about 3 minutes, tell an interesting story that incorporates most of these key points and leaves the recipient intrigued and wanting to hear more.

And remember that the desired outcome is exactly that: leaving the recipient wanting to hear more. So work on that: articulating what you are working on in a

way that will make investors, customers and partners wanting to hear more.

Once you have that, making some slides to go along with it will be easy.

Here are a few resources that may be helpful to you:

What Sequoia Capital says they are looking for in a pitch deck.

Sequoia Pitch Deck Template.

The Original Uber Pitch Deck

Excellent Post and Deck from Front's CEO

Coinbase Pitch Deck

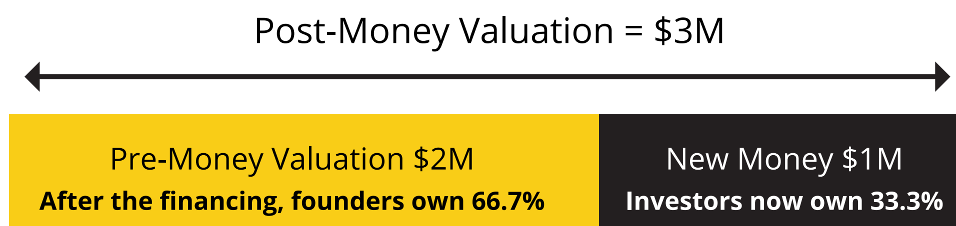
Y-Combinator Pitch Deck Template

Glossary of Startup Financing Terms

Equity Financing

Any financing where the investor is buying part of the company in return for the capital invested. The investor now has a claim to a percentage of all future profits of the company, and to a share of any future sale (or liquidation of the company). Unlike debt there is no operating repayment obligation, per se. The ownership share of an equity investor is always `New Capital / (Pre-money Valuation + New Capital)` So, for example, if we agree that Pre-money Valuation of the company is $2M, and the investor is putting in $1M, then the investor now owns 33.3% of the company (1/(2+1)). Simple math — the hard part with an early-stage company is agreeing on what the pre-money valuation should be.

Equity Financing Math:



Every equity financing transaction follows this simple math.

Preferred Equity

When an equity financing is done (see above), the investor may get equity that has certain preferential rights. The typical example is venture capital financing where the investor receives Preferred Stock, while employees hold Common Stock, and the Preferred Stock is senior to Common Stock in the case of liquidation of the company (ie, the investors get their money first before any distribution to employees and other common stock holders.

Debt Financing

With a debt financing, the company has an obligation to re-pay the capital, principal plus interest, over some amount of time. The debt holder (who loaned the money) has to claim of equity ownership of the company and no claim to any future profits of the company (beyond repayment of principal plus interest).

Revenue Sharing Note

Structured as debt, with the repayment defined as a percentage of the company's revenue. So, for example, it might be a $100,000 loan, repaid as 2% of the company's revenue for 48 months, capped at 1.5x the loan amount. This can be especially well-suited to seasonal businesses, which generate more cash in some parts of the year than others.

Convertible Note

A common investment structure for seed-stage financings, a convertible note starts as debt and then converts to equity upon some future trigger. A common scenario is to make is a 24-month promissory note, with interest accruing but no payments required, with conversion to equity at the company's next equity financing. So, let's say the company does a convertible note with an investor, and a year later the company does an equity financing with a venture capital firm. The note then automatically converts to equity at face value plus all accrued interest, at the same valuation as the venture capital firm has agreed to in the round.

SAFE Financing

Developed by Y-combinator as an alternative to Convertible Notes, a SAFE financing (Simple Agreement for Future Equity) is a popular seed-stage investment stucture in Silicon Valley today. The principle difference from a convertible note is the a SAFE financing is not a loan, it acts more like a warrant (gives the investor the rights to purchase shares in the future). SAFE financings can be conducted quickly, without the high legal expenses of an equity financing. See more information from Y Combinator.

Valuation Cap

With both Convertible Notes and SAFE's, the entrepreneur and investor are agreeing that the investment will convert to equity at an undetermined valuation in the future. In the case of a crazy-high valuation, the investor may feel this is unfair. Let's say I put $1M into a very early stage company and then two years later a VC firm says they'll do an equity round at $100M valuation. This means that my money will convert to 1% of the company and I'm going to scream bloody murder — I put a million dollars in when it was a high-risk early-stage deal, I should be more than 1%!! Putting a Valuation Cap into the Convertible Note or SAFE solves this problem. If we agree on a Valuation Cap of $10M, then I know I'll own at least 10% of the company, even if there is some crazy-high valuation at the time that my money converts to equity.

Warrants

Warrants are an instrument that gives the right (but not the obligation) to buy stock at a certain price for a certain amount of time. The price at which the stock can be bought is called the exercise price or strike price.

What you’ll need

The Funding Stack

Regardless of which of the many financing structures I’ve discussed in this booklet you choose to pursue, there’s a basic “Funding Stack” of materials that you will need for any investor discussion:

1. **Problem Statement.** Great ventures begin with an entrepreneur who notices a problem worth solving.
2. **Solution Statement.** How does your venture solve the problem stated above?
3. **Landscape of competitors and alternatives.** What are the alternative ways of solving the problem you solve? How do you fit into that landscape?
4. **Economic Model.** Some people might call these “Financial Projections”, but I prefer to think of them as a set of spreadsheets that show the economics by which your venture will create, deliver, and capture value.
5. **Capitalization Table.** A cap table is simply a spreadsheet showing who currently owns what percentage of the company (and how that might change after the financing).
6. **Growth Plan.** Getting the first few customers is hard. Getting the next thousand is really hard. Many startups fail during this process - how will yours succeed?
7. **One-sentence pitch.** Can you describe the entire thing in one sentence? If not, work on it until you can.
8. **Pitch Deck.** 8-10 slides (about three minutes) which includes a summary of all the above points (see the Pitch Deck chapter in this booklet).

Summary

There has never been a better time to find financing for your startup venture. In 2022 there are more sources and structures of startup capital than ever before.

For you as an entrepreneur, the key is to take the time to understand all the different options and then target the ones that make the most sense for your venture and your personal expectations.

Many people reflexively equate startup financing with Venture Capital, but VC is actually the right fit for only a small subset of startups. The VC business is based on buying equity in startups that need to scale at an unnatural pace and then will have an IPO that gives investors the opportunity to exit at 100x their investment. It's a business based on binary outcomes - bankruptcy or billion dollar exit. That's perfect for an Uber or an Airbnb, but not a fit for many other great businesses.

So take the time to figure out what's best for your venture. Understand stage and sector (if you're an early-stage medical device startup don't waste time pitching investors who focus on growth-stage software startups). Look for investment structures that will best allign the interests of the company, your personal interests, and the investors' interests. If you do that you'll be able to build a great company with happy stakeholders all the way around.

It's a great time to be an entrepreneur. Here's to great success with your fundraising and your entrepreneurial journey!

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Silicon Valley
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Bret Waters has been in Silicon Valley his entire life as an entrepreneur, CEO, investor, and academic. Today he teaches entrepreneurship at Stanford, runs the 4thly Startup Accelerator, and coaches startup CEO's at Miller Center for Social Entrepreneurship. The entrepreneurs he has worked with have gone on to raise hundreds of millions of dollars in capital and are operating all over the world. Previously he founded and ran three Silicon Valley software companies, married an awesome woman, and now has seven kids and two great dogs. He received his MBA from the Kellogg School of Management at Northwestern University.

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