Raising Equity Funding

Key Considerations

JOHNSTON CARMICHAEL

Founder objectives

From the outset, as a founder you need to remember this is your business. You are creating this business for you and your co-founders and you should not feel compelled to follow the established path if it will not deliver what you want.

As founders you will have to make some important decisions early on, based on your own ambitions and the value proposition of your business. Funding strategy is critical. If the ambition is to create a fast growth business of scale, you need to identify investors who are aligned to that strategy. Early-stage investors may be able to follow their money but will also recognise the need to bring in later-stage growth capital and will be realistic about dilution and loss of investor control.

If the objective is to achieve a more patient growth plan or to develop the business to a point where it is of strategic interest to a trade purchaser, the funding strategy may look very different and early-stage investors may indeed be the only investors required. You may decide that you don't want to raise any external investment, instead relying on self-funding and re-investment of sales revenues to help grow the business.

Keep your own objectives front and centre when considering your funding strategy. At Johnston Carmichael we can provide objective, independent advice to support you in these areas.

How much should we raise?

If you are wrestling with this question – don't worry, you're not alone! Every founder asks themselves this question repeatedly until they don't need to raise any more capital.

In simple terms, you want to raise enough capital to deliver strategic step changes, which increase the value of your business.

How much is enough?

You need to look critically at your cash forecasts and overlay the commercial objectives you will deliver over that period. For example:

1. Product prototype
2. Regulatory approval
3. IP protection granted
4. Pilot trials
5. Early customer traction
6. Proof of sales/growth strategy e.g. channel sales
7. Securing repeat business from target customers
8. Achieving cash breakeven
9. Selling into a key target market

The above list is not exhaustive but should give you a feel for strategic objectives which will deliver value inflections. These are proof points and in general, anything which proves that the company's product or service addresses the needs of the market will help drive your valuation.

Why raising to little could be an issue

Raising too little will provide insufficient runway resulting in management time being spent on the next fundraising round, rather than delivering the business objectives. It will also lead to compromises, slower progress, and the risk of failing to deliver on the agreed objectives set pre-funding.

Can you raise too much?

In our view, yes. Raising too much capital at an early stage can increase execution risk due to:

- **Loss of focus**: if there is money in the bank, it is difficult to say no to 'pet' projects.
- **Pressure to scale too quickly**: building the right team takes time. If there is pressure to 'go quick' that can lead to problems in recruitment and investment in the wrong areas at the wrong time (e.g. investment into sales ahead of determining product-market fit).
- **Risk of a future down round**: a high bar has been set and if further funding is required, a new investor may have a different view if progress has not been what was promised.

In summary, aim to raise what you can justify in terms of the target objectives for at least the next 12-18 months and give yourself some headroom in case of unexpected events (e.g. a global pandemic!).

Valuation and dilution

Dilution is part and parcel of raising investment, however the aim is to grow value, resulting in you having a smaller slice of a much larger pie.

Investors want the company's management team to remain incentivised and as a result, they will aim to achieve a proportionate dilution where there is a degree of 'mutual discomfort' for all parties.

That is not to say there are not bad actors out there. We have seen examples of what we consider to be poor term sheets, but they tend to be at the smaller end where investors look to invest relatively small sums of money (via SEIS). Potential areas to be wary of include:

- Relatively small sums of money that don't 'shift the dial' (<£100k)
- Onerous restrictions on how you can spend the money and/or minimum cash retentions without investor consent (which effectively reduces an already modest investment)
- Warrants to subscribe for further shares on favourable terms, irrespective of company performance
- Excessive charges relating to the investment and/or ongoing monitoring fees
- Undue pressure to move quickly

If in doubt, take advice. At Johnston Carmichael we see a lot of term sheets and can benchmark proposals against what is reasonable.

We can provide you with a template share cap table which you can use to run scenarios based on raising different amounts, valuations and share option pools for your team.

1. The amount being raised
2. The pre-money value of the company
3. The number of times you raise money

Valuation

Valuation is a key factor in dilution. At an early stage there is generally no objective basis for applying a value to a start-up. The company may be pre-revenue or even pre-product, therefore how can a pre-money valuation be determined?

The answer is that the pre-money value is the result rather than the starting point:

1. The company requires £x of capital
2. The investor requires to hold enough skin in the game to make it worth their while (a significant minority stake)
3. The investor recognises the need for the management team to be aligned to the objectives of growing value and so dilution must be proportionate.

A 'significant minority stake' will be somewhere in the range of 15% - 35%. If the company is looking to raise £500k, at 20% for the investor, the pre-money valuation will be £2m and at 30%, the value will be £1.17m.

There are a wide range of factors that investors consider when weighing up an investment decision:

- Strength and experience of the management team: this is crucial. If you are an inexperienced management team, try and bolster that with an experienced advisory board / non-exec directors
- Size of the opportunity: what is the addressable market?
- Product differentiation: stage of product, IP protection, competitive advantage
- Customer engagement and traction
- Marketing and sales channels: are there established channels and can you prove this?
- Comparative transactions in the sector: previous exits in the space
- The need for further investment

Ultimately it comes down to negotiation and founders can strengthen their hand by looking to address the above points and by:

- Making it competitive: having more than one interested investor
- Engaging with investors who have previous success in your sector

A final point on dilution

There is increasing evidence that the number of times a company raises funds has a greater impact on founder dilution than the quantum of funds raised. Bear this in mind in your funding strategy - for example, raising £1m seed, £5m Series A and £20m Series B is likely to deliver less founder dilution than raising £250k pre-seed, £750k seed, £5m Series A and £20m Series B.

Of course, this is easier said than done!

Problem areas

Founder protection

It is common in early-stage investments for founders to agree to good/bad leaver scenarios and reverse vesting. It is important that these are reasonable and proportionate based on the stage of the business, and there should always be flexibility for the Board/investor to relax the provisions where appropriate.

Equity in the wrong hands

Related to the point on founder protection, problems can arise when significant equity is deemed to be in the wrong hands. This can happen if a co-founder has left the business prior to a fundraising. It can also be an issue in relation to university spin-outs, where academic founders who are remaining in the university have a large shareholding and indeed where the university itself is deemed to have a disproportionate holding.

These issues can lead to complexities and be a disincentive for investors.

Process

It is important that you adopt a structured approach to a fundraising exercise. Preparation is key and you should carefully research potential investors and leverage your networks and those of your Board and advisers.

In our opinion, it is important for the company to take the lead on a fundraising process, particularly for sums up to c£5m. As advisers we can guide you on the collateral (pitch deck/forecasts, etc), help you prepare your pitch, introduce you to potential investors, and support on other areas such as investor tax reliefs, review of term sheets, and due diligence. However, we believe it is important for the management team to demonstrate to potential investors that they can take the lead, rather than relying on advisers. In later stage investments, it will often make sense to use advisers.

As part of your preparation, you should try and run your pitch past 'safe' investors. We will typically introduce someone known to us who we trust to give an honest, independent, investor perspective on the proposition, and that feedback can be invaluable.

We would also recommend that you:

- Don't approach all target investors at the same time. Do an initial sample and take stock – is there a consistent theme to any feedback which might warrant a change of approach?
- Leave your preferred target investors until after the initial batch. You will feel more confident, be better prepared to anticipate the questions, and have the opportunity to adapt to any changes based on feedback from the initial conversations.

If you are looking at a later stage round, then you will likely be building engagement with target investors over a long period of time. An initial conversation about what you are doing, followed up with regular updates on what you say you are going to do, and what you have done since the last update, will build engagement and confidence that you as a management team can execute successfully.

Financial forecasts - yes or no?

We often see founders being asked to provide integrated financial forecasts for a 3-5 year period. Some investors like them, some think they are irrelevant.

If you are at a very early stage and are a year or more away from generating revenues, then it is critical you know how you will deploy cash and how long a runway an investment gives you. In those cases, a 3-5 year financial plan with revenue forecasts after year 2 are extremely limited in value, other than perhaps supporting the size of the opportunity.

In those circumstances we recommend having robust projections of cash for a period up to a point where the next funding round will be anticipated. If a specific investor requires more than that, you can consider that request based on how keen you are to secure their investment.

If you are raising funds to scale up then detailed financial forecasts of profit, cash, and balance sheets are relevant as you need to demonstrate how the business scales. Within your forecasts try and capture the relevant KPIs that you can summarise in your pitch deck.

At Johnston Carmichael we have a specialist financial modelling team who can build bespoke models that not only help with fundraising, but serve as an ongoing planning tool.

Get in touch

If you would like to discuss any of the points we have covered here in more detail with one of our sharp minds, please don't hesitate to get in touch.

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