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Tips for Startups – Understanding the Stages of Equity Financing

In the earliest stages of a new venture, founders will often seek to bootstrap (i.e., self-finance) operations in order to build value through their own sweat equity. Once bootstrapping is no longer enough to sustain their pre-revenue startup, or the need for financing to grow the business outstrips modest initial revenues or friends and family contributions, it becomes essential for these founders to begin looking for external sources of financing. If conventional bank loans and lines of credit are not desirable or sufficient, then they may consider seeking private investment. For founders unfamiliar with fundraising, it can be very daunting when terms like “angel investing”, “venture capital”, “series B financing”, and “seed round” are being thrown around. Understanding the terminology surrounding the financing process is essential for startup leaders hoping to secure financing, or for individuals in the business world hoping to understand the startup landscape.

What is equity financing? Who participates?

When many people hear terms like “venture capital”, they think of television programs like Dragons’ Den, in which business founders pitch their ideas to a group of wealthy and successful business personalities. Much like in Dragons’ Den, the process of early-stage financing involves investors providing funds to startup companies that have potential for long-term growth. Early-stage equity financing is a great option for startups that are not in a position to seek funding through public capital markets, and wish to avoid being loaded with debt. Investors involved in early-stage equity financing generally take on a relatively high risk due to the youthfulness of the companies they invest in, so they will often seek additional rights, such as a seat on the board of directors, in order to have some say in company decisions.

Equity financing can be provided by a variety of sophisticated parties such as angel investors, venture capital firms (often simply called VCs), private equity firms, and sometimes even investment banks.

While there can certainly be some crossover, angel investors and VCs have some key differentiating features, which inform their investment strategies. Angel investors are generally wealthy individuals with an entrepreneurial or executive history who invest directly in the early stages of a company's development, often investing their own capital. In contrast, VCs are generally larger institutional firms, investing from a fund of pooled assets raised from their own investors. While both angels and VCs will commonly contribute experience, knowledge, and a strong network to the company, angels are frequently attracted at a pre-revenue stage, investing in individuals and ideas that may not have proven commercialization. VCs, on the other hand, often target companies that are emerging from this initial growth stage and have some proven market capability.

A novel method of financing has emerged through crowdfunding. Equity crowdfunding allows a limited number of individuals to purchase a limited amount of private company securities online. This process circumvents the requirement of filing a prospectus, based on startup crowdfunding exemptions available in certain jurisdictions. The main difference between equity crowdfunding and other crowdfunding platforms like Kickstarter is that equity crowdfunding involves the purchase of securities in exchange for equity ownership in the company, as opposed to simply providing donations or pre-orders for products or services.

What are "rounds of financing"?

Capital is generally provided at various stages, or rounds, as this ensures that certain goals are met before further financing is provided. While there is no hard and fast rule that a company has to proceed with their financing in a particular sequence, typically the rounds of equity financing can be viewed as follows: seed/angel round, series A, series B, series C (followed by D, E, etc. as needed), and an exit.

Seed round

The seed round is the earliest round of financing, often provided by the company's founders, friends and family, and angel investors, either together or within their own distinct seed rounds. Additionally, equity crowdfunding is becoming more common as a means of augmenting capital raised at the seed stage. It is less common to see institutional VC investors at this stage. Seed capital is a high-risk investment that is often offered in exchange for an equity stake in the enterprise. Because the seed round is often financed by angel investors, some simply call it the "angel round". The term "angel round" denotes who the round is funded by, whilst "seed round" refers to the stage of the company's development when they are being funded.

Seed capital is the initial capital used to start a business in the idea or conceptual stage. This capital is typically pre-production financing used for product research and development, consumer and marketplace research, operating expenses, and advancement to a stage of operation that will be attractive to investors. Seed capital helps companies get off of the ground and begin building momentum. This funding allows the company to mature for some period of time and become more established, such that VCs will eventually view the investment as lower-risk. In other words, this stage plants and nurtures the seed (i.e., the idea of the startup) so that it matures into a fully grown operating business.

Series A, B, and C Financing (the Institutional Rounds)

These financing rounds generally coincide with growth goals, as the company continues to ramp up operations developed using the seed funding, with a trajectory generally aimed at going public or becoming involved in an acquisition or merger at some point in the future. This is most often the stage at which institutional VCs become interested in funding the startup, because the company has become more established and entered the marketplace, but still has potential for growth. In addition to institutional VC investors, other parties such as angel investors, investment banks, and larger private equity firms may become involved, while equity crowdfunding may continue to play a role in financing.

Between each round, a company may also seek bridge financing. Generally, bridge financing involves a smaller amount of money, often issued as convertible debt, that is used to keep business operations running smoothly between rounds. These rounds are typically labeled as Series A, B, C, etc., as a method of keeping their order clear. While there are rules as to how a Series A is structured versus a Series C, for example, there are still some general commonalities between the rounds.

Series A Financing (Start-up Round)

Series A financing involves early stage startups that need funding for early sales and manufacturing costs, along with marketing and product development requirements. At this stage, the company typically has some customers or users, a realized product, and a need to expand marketing and sales beyond their current customer base. Angel investors may participate in this round, but will likely have less influence than in the seed round, as more traditional VC firms will become involved at this stage.

Series B Financing (Second Round)

In this round, funding is generally sought to further expand market reach, assist in continued development and acquire talent in the startup. As the company grows, more people will need to be employed including IT professionals, sales and advertising experts, and employees filling business development roles. Some companies may also seek to scale up from regional to national platforms or into bigger markets. By the time a company reaches this round, it will already have a solid customer base and the means to service these customers; thus, the goal of this round is to develop a competitive advantage in the marketplace. Series B financing may attract VC firms that are particularly specialized in later-stage financing.

Series C Financing (Third Round)

At this point, the goal is generally to perfect the business model and continue to scale. Common methods of scaling at this stage may involve expansion into other regions or acquisition of other companies using the Series C funding. By the time a company reaches Series C, investment in the startup will be less risky, as there is now a history of success and the company has become a known commodity. For this reason, more investors will come out of the woodwork to invest in the company, including hedge funds, investment banks, and private equity firms. By the end of this stage the company will ideally have reached significant market share. Some companies may continue this process into Series D, E, and so on, while others may begin to position themselves for an initial public offering (**"IPO"**) or a private acquisition. Generally, it is rare to continue much further than Series E, but this is specific to the individual company and its business plan.

The Exit

Typically, an exit will involve a merger, acquisition, or an IPO. The exit stage can provide massive return for founders and investors alike, and serves as a substantial incentive for their initial investment. This stage is not mandatory, however, and some companies will instead remain private and continue to operate as a profitable going concern, returning dividends rather than a lump sum exit.

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Bootstrapping and other forms of self-financing can be very important at early stages of development, where founders are protecting their own stake in the company. However, when additional funds and expertise are needed, the process of seeking equity investment begins. Finding not just investors, but the right investors, is a challenging process, and can require a great deal of time and effort on the part of founders. A great deal of due diligence will be required by potential investors before they become interested in investing. Sophisticated investors want to see companies that are well managed, with their legal affairs in order, and with a fully developed business plan. Additionally, the industry-specific expertise that different investors may bring can have its own value, so seeking out a network of individuals and organizations with the relevant industry knowledge and experience is important as well.

The stages of financing do not necessarily fall into air tight components, but rather act as checkpoints during a company's evolution. Sometimes stages will overlap, and some may be skipped completely. Speaking with your legal and financial advisors early on will help you set up the best structure for your growing company.

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a cautionary note

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