INSIGHTS ON CAPITAL SERVICES

The Latest Trends in Funding Aren't for Everyone Just Yet

Like many things these days, the business of raising money is always changing, and can be quite different depending on where you are, not just in the life of your business but literally in the place you source capital. As we've talked about before, there is a time in a founder's growth for debt and a time for equity – for more on that, watch the Acresis video on debt vs. equity. Typically, when a founder starts a business, he or she looks to their own personal balance sheet first and then often to friends and family who more than anything want to support the individual as much as they want to support the actual business (often synonymous for these investors).

Video: Acresis Founder Partner Bill Weather talks about debt vs. equity

This type of inner-circle funding often lacks guide rails like due diligence or consideration of different types of equity. That's not necessarily bad, but the use cases are really all over the map. As a result, when founder-owned businesses grow and need more capital – debt or equity – their readiness to raise money varies widely as well. Needless to say, there are differences and challenges as founders go from inner-circle funding to institutional money, whether that is a bank or professional investors.

In the tech space, which is an area of heavy focus for Acresis, Silicon Valley has a beacon effect on the rest of the industry. Business practices there, including approaches to funding, tend to spread out across the industry and other regions. We imagine that this will only compound over time since it's hard to find an emerging high-growth business that does not employ technology in some way. At the same time, there are still *major* differences in how funding works up and down Sandhill Road versus how it works everywhere else. More on that in a moment, but let's back up for a second…

When founders get started it is not uncommon to have funding from multiple people, contributing a range of investments – e.g., we've seen as many as 25 or more people in a founder's initial cap table, all with the same class of shares and none with any preferential treatment. The money flows, the business grows and eventually the capital needs and complexity outstrip the appetite and capacity of first-round investors. Friends and family financing usually works for the first \$2 M to \$3 M, though we have seen capital pools with this model as large as \$35 M. Either way, if you are growing like the companies we work with often then that well will eventually run dry.

At this point, if you're a typical founder-owned business, you may go out for an institutional raise with a whole new set of terms and conditions (and definitely guard rails). At this point, new terms and concepts emerge – things like "non-participating preference", "participating preferred", "preferred returns", "waterfall" …the list goes on. The traditional gold standard for professional investors and their portfolio companies has been participating preferred stock, which means issuing a new share class of stock on top of previous friends and family investments with new and different rights that almost certainly trump the rights of prior investors. Such stock also comes with an interest rate or "preferred return" – e.g., a first-time institutional investor might put in \$3 M with a rate of 7%.

Now, let's see how this plays out. Upon any liquidity event for the Founder and company, payout on original friends and family stock would occur *pari passu* or "on equal footing" as the industry term goes. But with preferred shares the concept of a waterfall comes into play. The later stage institutional investors get paid out first: on their preferred return (the interest rate, if you will) and on the face value of the preferred equity they committed and according to their ownership percentage. Typically, the lower the potential for upside return on the equity, the higher the interest rate, and vice versa. After preferential investors are made whole, then everyone else gets paid. That's how we *used to* raise money, and pay out.

But back to our beacon. In Silicon Valley investment partners have begun to move to non-participating preferred stock. In this model, the non-participating preferred investors are given a choice. Choice A would be to take their payout pari passu with all other investors, while Choice B would be to just get their invested capital back with interest (preferred return). Choice A works great when companies hit home runs – all boats rise on a rising tide and the interest is "too much" because the payout is already so large – while Choice B is basically investor insurance for when companies fail to produce target returns, and since this happens more often than not we have the "traditional" approach of participating stock and preferred returns.

Bill Weathersby on the Intacct Panel in Dallas

This new model with these two choices offers downside protection without "over compensating" investors for upside. The Googles and Facebooks of the world no doubt appreciate this, and many of our own clients would no doubt appreciate Choice A, as well. But while this is becoming trendy in Menlo Park, it is virtually unheard of in many of the other places where we do business, like Texas or even up and down the Northeast Corridor in cities such as New York or Boston. So, when Founders we work with call us to say that their buddy in San Jose just garnered an institutional round with non-participating preferred stock, we remind them that what's happening in the Valley is, for now, unique to the local economy shall we say.

This is just one of the nuances and "been there, done that" lessons that experienced investors and founders have learned, sometimes the hard way. Stay tuned for our next installment of trends in capital services when we talk about why one of the best times to get a Line of Credit is after your first big round of intuitional equity funding, which can often make your cost of capital amazingly low if you manage the balance between debt and equity properly.

To learn more, visit us at www.acresis.com.