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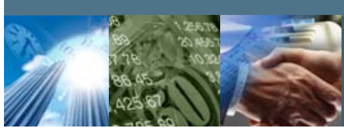
How Start-Ups Raise Money

Entity Structure

- Typically, a start-up is organized as a limited liability company or incorporated as an S corporation
- Corporate housekeeping is essential for both
  - To ensure founders are clear on structure details
    - Ownership
    - Governance
  - To withstand investor due diligence
- S corporation limitations relevant to raising money
  - No foreign stockholders
  - No more than 100 stockholders
  - No entity stockholders
  - One class of stock (although voting and nonvoting common stock are permissible)
- Wise to limit transferability
  - S corporation: Stockholders' Agreement
  - Limited liability company: Operating Agreement

Financing (Corporation)

- Seed Stage (up to $1,000,000): "Friends and Family"
  - Debt (avoids valuation exercise)
    - Business Plan
    - Investor Qualification Questionnaire
    - Subscription Agreement / Note Purchase Agreement
    - Promissory Note
  - Convertible Debt (defers valuation exercise)
    - Business Plan
    - Investor Qualification Questionnaire
    - Subscription Agreement / Note Purchase Agreement
    - Promissory Note



Financing (Corporation)

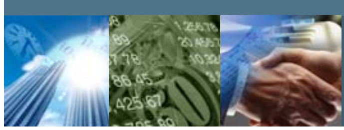
- Seed Stage (cont)
  - Common Stock
    - Typically, seed investors get ½ to ⅓ of equity (dilutable), meaning valuation range of $500,000 - $3,000,000
    - Advisable to arrange for a Voting Trust if more than 10 investors
    - Documents
      - Business plan / private placement memo
      - IQQ
      - Subscription Agreement
  - Occasionally, representative of seed stage investors gets a board seat – often one of three

Financing (Corporation)

- Series A Preferred Stock Round
  - Investors can be
    - Venture capital company
    - Angel funds
    - Individual angels
  - Funding size range: $250,000 - $10,000,000
  - Valuation range: $2,000,000 - $25,000,000
  - Triggers conversion of convertible debt, often at 10% - 15% discount
  - Documents:
    - Charter amendment
    - Stock Purchase Agreement
    - Investor Rights Agreement
    - Voting Agreement
  - Investors get a board seat (second of five)

Financing (Corporation)

- Bridge Loans
  - Overused expression
  - Properly used to describe a short term loan advanced to bridge the gap between an early preferred stock round of financing (Series A or Series B) and a mezzanine round of financing
    - Lender can be individual angel, angel fund or bank, such as Square 1 Bank
    - Often secured by blanket lien on all assets
    - Often less than one year term, ballooning as to principal and interest
    - Interest range: prime plus 2-6
    - Warrants often attached
  - Senior obligation, requiring existing lenders to subordinate
  - Non-bank lenders often get a board seat; bank lender often gets board observation right

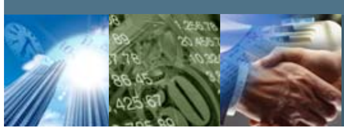


Practical Considerations

- Should be covered in the Business Plan text or the appendix
  - Management team is the key
    - Education
    - Work experience
    - Level of personal commitment
  - Support from third parties
    - Purchase commitments
    - Testimonials
  - Definition of the market and the strategy for grabbing market share
    - Credibility essential in definition
    - Leave no rock unturned
    - How long until cash flow/ what more is needed to get there
    - Set out range of expectations

Practical Considerations

- Will acquired assets/ developed assets be bankable?
- Strength of acquired/ developed intellectual property
- Suggestions for financing milestones: “tranches”
- It’s “**<u>Who You Know!</u>**”



Exit

- IPO market viable
- Reverse mergers popular
- Acquisitions and mergers still most common exit
- Redemption remains last place option