

How does a startup raise capital from investors?

The purpose of this article is to provide a framework for startups to create their specific plan to raise capital from investors.

This article has a limited scope and does not address all situations.

- 1) The focus is on startups, not established companies raising billions from an IPO or Private Equity.
- 2) The assumption is that the startup is not bootstrapping i.e. launching and growing the startup using the founders' personal savings and borrowing combined with friends and family.
- 3) The types of investors include: individual investors, angel investor groups, various types of investment funds including venture capital, and family offices.
- 4) This article does not address government funds (loans, grants, tax credits, etc.), accelerators which invest equity, venture studios¹, corporate venture capital², listing on a stock exchange, crowdfunding, etc.
- 5) This article does not address the many different types of capital: common stock, preferred stock, convertible notes, venture debt, SAFE, etc.
- 6) This article refers to fact-based research. This research is from the U.S. I was not able to find applicable fact-based research for the Toronto ecosystem.

The startup may utilize multiple sources and types of capital.

What can you learn from fact-based research?

200 startups that successfully closed their round.⁴

- 1) The average seed stage round takes 12 ½ weeks.
- 2) 20% of the startup require 20 weeks or longer.
- 3) 20% of the startups require 6 weeks or less.
- 4) The longest successful round raise took 40 weeks.
- 5) Approximately 90% of the startups closed their round by contacting less than 75 investors.
- 6) Companies that failed to raise a round gave up after an average of 6.7 weeks.
- 7) Funding led by a seed stage fund is more efficient than one led by angel investors. (average time to fundraise: 9.6 weeks vs 13.5 weeks; average number of investors contacted: 29 vs 68; average number of investor meetings: 27 vs 45; average money raised: USD \$2 million vs USD \$989,000). However only 3% of seed stage startups are funded by seed stage funds.
- 8) The average time spent by an investor to read a pitch deck is 3 minutes and 44 seconds, with 12% of investors reading the deck on their phones.

The key implications are:

- 1) If you have not closed your round after contacting 100 investors, you must do a fundamental rethink about whether or not you have a viable startup or whether your targeting the wrong types of investors.
- 2) Don't give up early. 20% of the time it may take 20 weeks or longer.
- 3) You must research to understand what each seed fund is looking for. Your pitches and material should answer the fund questions before they ask them. My observation is that many startups don't do this research and as a result are quickly eliminated by the seed funds.

How much time should you target between fundraising rounds?⁵

A fund-raising round can take a long time. This research study examined 13,916 financing events.

- 1) The average time between fundraising rounds was 20.6 months.
- 2) The time between rounds ranged from 6 months, to 35 months, 68% of the time. i.e. 16% of the time less than 6 months and 16% of the time longer than 35 months

What are the 3 greatest contributors to startup failure?⁶

This research study analyzed 101 startup failures and identified the most frequently cited reasons for failure. Usually there were several reasons for failure.

- 1) 42% of the time built a solution looking for a problem i.e. no market need.
- 2) 29% of the time running out of cash.
- 3) 23% of the time, not the right team.

My personal observation is that I've lost track of the number of startups where:

- 1) The only understanding of the market size is a slide they copied from a consulting firm that said the market size was \$10s of billions. Seed stage funds immediately eliminated these startups because there was no understanding of market need or size.
- 2) There was no monthly cash flow forecast which considered the length of time required to raise capital and the time between fundraising rounds.
- 3) The founding team was incomplete and could not communicate their relevant experience.

Few pre-revenue companies are funded by third parties

- 1) Only 3% of angel funded companies are pre-revenue.⁷
- 2) There are pre-revenue funds, but they represent a tiny fraction of all funds.

My own observation of angel investments is that the majority go to revenue generating companies.

The framework for raising capital has 13 stages.

The 13 stages overlap and are not all sequential.

Stage #1 24-month cash flow forecast, by month with monthly milestones – this is a minimum time frame

- 1) The cash flow forecast reflects the time necessary to raise capital and time between financing rounds.
- 2) Plan to use your own funds, plus friends and family funds, to get your company to the point of have a few delighted cash paying customers.
- 3) The planned milestones reflect the major accomplishments investor would expect to see. There is a clear relationship between capital used and business accomplishments.

Stage #2 Decide upon the types of capital and capital sources in this round

Define your requirements for an investor e.g.

- 1) Are they a lead investor?
- 2) Do they have the same values and interests in growing your business as you do?
- 3) How soon do they want to exit?
- 4) What is their reputation?
- 5) Are they easy to work with? What do other startups say about them?
- 6) Should they have relevant industry experience?
- 7) What functional experience should they have?
- 8) What capability should they have to introduce: other investors, potential customers, potential suppliers and partners, potential employees, etc.
- 9) Should they have the financial capability to continue to invest in future rounds?
- 10) What value could they provide on a board of directors or advisory board?

Stage #3 Build your information pyramid⁸

- 1) The information pyramid outlines the varying types and quantities of information the startup communicates to potential investors. This includes the various types of oral and written pitches.
- 2) The top of the pyramid has limited information, with each succeeding layer having more.
- 3) The pyramid includes your data room for due diligence.
- 4) A startup has a plan and process for managing this information pyramid with potential investors.
- 5) The approach varies depending upon the stage of the startup e.g., a founder dealing with friends and family is different from a billion-dollar IPO.

Stage #4 Prepare a list of capital sources

- 1) All your existing investors are potential capital sources.
- 2) Based upon your requirements from Stage #2, prepare a target list of capital sources.
- 3) Try to make this target list global in scope. Angel groups from the U.S. are investing in Toronto startups. Some global funds from the early stage to post Series A are investing in Toronto. Many U.S. funds are investing in Toronto.

Stage #5 Arrange warm introductions and send out cold call emails

- 1) Only 12% of closed deals result from cold call emails to funds. Warm introductions are critical to fundraising success.⁹
- 2) You have to research your own network to find out who knows someone at your target investors.
- 3) Touch base with those people. Send them an email which they can forward to the target investor they know.
- 4) Use a CRM to manage the amount of information you're collecting, and people you're phoning and emailing.

Stage #6 3 weeks of non-stop meetings

Schedule investor meetings for a 3-week period. Your CRM will be crucial
You will be totally consumed during this time,

Stage #7 Investor Due diligence

- 1) Interested investors may conduct due diligence within 3 weeks.

Stage #8 Term sheet negotiation and agreement

- 1) Negotiating and finalizing a term sheet may take up to 6 weeks.
- 2) At least one of your advisors needs to assist you as you contemplate business terms.
- 3) A lawyer with deep experience in startups is valuable.

Stage #9 Get the money in the bank

- 1) Fundraising is only complete once you have the money in the bank. Some founders have told me that they've had investors who failed to actually provide the money.

Stage #10 Implement your revised governance framework

- 1) Your investors may be involved in decisions. This decision-making involvement must be documented to ensure a common understanding, along with establishing the necessary processes.
- 2) Your investors may also have stated their ongoing information requirements. You'll need to put the necessary processes in place.

Stage #11 Send out monthly updates to potential investors⁸

- 1) You must stay in touch with the investors who did not invest.
- 2) Your monthly update demonstrates month by month accomplishments, with the focus on increases in the number of customers and revenue.
- 3) Consider including advisors and others in this monthly update.
- 4) Your CRM will manage who you send the updates to and track who actually opens them.

Stage #12 Send put monthly updates to existing investors¹⁰

- 1) You must send out monthly updates to those who have entrusted you with their money.
- 2) Do this even if its only friends and family.
- 3) Your CRM will manage who you send the updates to and who actually opens them.

Stage #13 Keep the information pyramid up-to-date, especially the pitch deck

- 1) You will need to enhance your CRM to meet the additional information reporting requirements of your investors.
- 2) You never know when an investor that you've decided you want, will express major interest.
- 3) You have to be ready.

Your next steps

- 1) Prepare your 13-stage fundraising plan to reflect your startup's specific situation.
- 2) Implement a project management tool and CRM.

Footnotes

¹ A venture studio is an organization that creates startups, typically by identifying a market need, assembling the initial team, strategic direction and providing the capital to launch.

² Corporate venture capital is where a large firm takes an equity stake in a small but innovative or specialist firm, to which it may also provide management and marketing expertise; the objective is to gain a specific competitive advantage.

³ SAFE stands for Simple Agreement for Future Equity. At the early stage of a startup, it can be difficult to accurately assign a value to the company because there is usually very little data. A SAFE is a form of convertible security that allows you to postpone the valuation part until later on. A SAFE is neither debt nor equity, and there is no interest accruing or maturity date.

⁴ "What we learned from 200 startups who raised \$360 million", Professor Tom Eisenmann, Harvard Business School, and DocSend

⁵ <https://medium.com/journal-of-empirical-entrepreneurship/how-much-runway-should-you-target-between-financing-rounds-478b1616cfb5>

⁶ <https://s3-us-west-2.amazonaws.com/cbi-content/research-reports/The-20-Reasons-Startups-Fail.pdf>

⁷ Angel Capital Association and Hockeystick, "2019 ACA Angel Funders report "

⁸ This outlines the various components of the information pyramid. <http://koorandassociates.org/points-of-view/selling-a-company-or-raising-capital/how-does-a-startup-communicate-with-potential-investors/>

⁹ Paul Compers, Harvard Business School, Will Gornall, University of British Columbia Sauder School of Business, Steven N. Kaplan, University of Chicago Booth School of Business, Ilya A. Strebulaev, Graduate School of Business Stanford, "How do venture capitalists make decisions", April 2017, Page 41 This survey of VC firms included: 63% of all VC US assets under management, 9 of the top 10 VC firms and 38 of the top 50 VC firms.

¹⁰ <http://koorandassociates.org/points-of-view/selling-a-company-or-raising-capital/how-can-portfolio-companies-update-investors/>