Raising early stage capital

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In brief

In the early years of building a start-up, founders often overlook key corporate, legal, tax and financial hygiene matters in favour of developing their product, finding market fit and acquiring customers. This is a risky approach that is largely the consequence of limited available funds.

Once a company has achieved the threshold milestones of technical and consumer validation, and is seeking external capital for expansion, it is critical to best position the company for a successful capital raise and future expansion.

PwC's Emerging Companies and Venture Capital team works with venture capital clients and the emerging companies in which they invest to help negotiate and close early stage funding transactions efficiently and fairly.

This ***LegalTalk Alert*** is designed to provide an overview of the capital raise process and address some frequently asked questions to help founders determine whether they are investor ready.

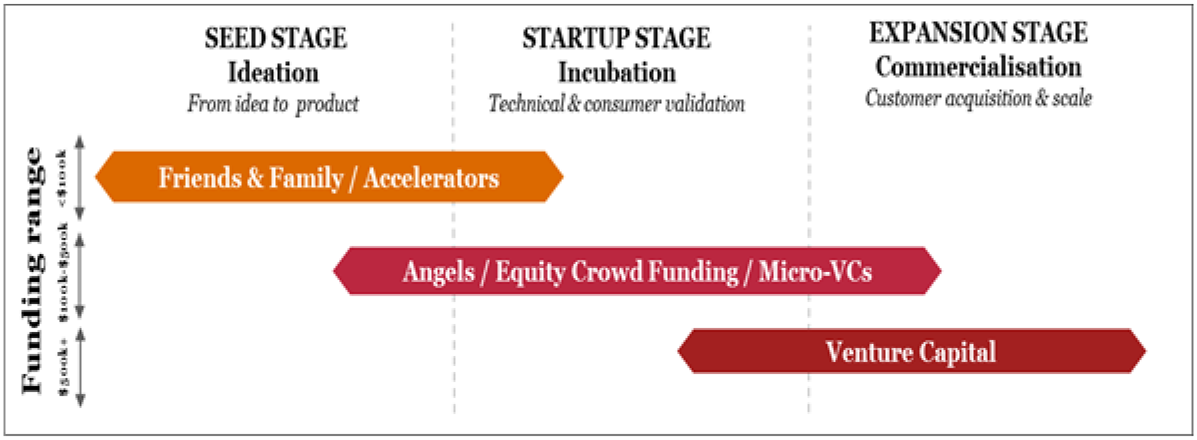
In detail

At PwC, we meet many companies contemplating a capital raise and many face similar issues regarding investor readiness and the fundraising process. We've highlighted many of these below, to assist founders prepare for and navigate the capital raise process.

Stages of development & funding

Start-up companies generally go through predictable development stages.

The earlier the stage of development, the greater the commercialisation risk and therefore the more challenging it is to attract external investment. As a start-up progresses through the stages of development and de-risks its business by validating its product, securing paying customers and beginning to scale, the more investable the business becomes and the higher the potential valuation the founders may expect to secure.



Seed stage – from idea to product

At the seed stage, founders will generally be developing the business idea based around a number of assumptions about the market and the opportunity. During this stage, founders will be focused on developing a proof of concept product or service that can be tested in the market and will generally be pre-revenue.

During this stage, founders will be considering how to structure their business (usually in a company) and how they will hold shares in the company.

Seed stage funding requirements vary depending on the sector. These early funds generally come from the founders' personal savings, credit cards, and investment by family, friends and possibly angel investors within the founders' own networks. Founders have also participated in equity crowdfunding where equity crowdfunding platforms can be a good vehicle to structure and execute small capital raisings from friends and family. Given the imminent changes in the Australian legislation to equity crowdfunding (essentially expanding its availability beyond 'sophisticated' investors - set out in more detail below), it appears likely that more companies, as well as investors, may consider this as an option.

In addition, companies at this stage are often undertaking research and development and therefore may be eligible for tax incentives (including cash refunds) as a result of the R&D tax incentive program.

This funding enables the founders to develop the product or service to the point where they can launch the business and start acquiring customers.

At this stage, the company is generally most suited for participation in an accelerator program, which also attracts a small amount of funding.

Start-up stage – technical & consumer validation

At the start-up stage, the founders should have built an early prototype product and have documented plans for the growth of the business, but usually will have no, or very few, customers. During this stage, the founders will be focused on launching the beta product and acquiring early customers. From early customers, the founders obtain valuable feedback about the assumptions upon which the idea was built, allowing the founders to alter the product, the pricing and the marketing accordingly.

Start-up stage funding will generally range from $100,000 to $500,000. These funds generally come from government grants, angel investors, equity crowdfunding platforms and micro venture capital funds.

This funding enables the founders to develop and refine their beta product (technical validation) and secure early customers (consumer validation). During this phase, founders should have tested early assumptions (and made any necessary changes to the business model or product), developed a clearer understanding of the consumer problem or market opportunity, and developed a customer acquisition strategy and resourcing plan that they are ready to implement in order to scale the business.

It is at this stage that start-ups are ready to consider implementing an expansion strategy to increase customer acquisition and scale the business.

Expansion stage – customer acquisition & scale

During the expansion stage, a company will start to formalise business processes, escalate marketing efforts and scale up customer acquisition. It may also continue developing and making improvements to its product or service.

Expansion stage funding will generally be upwards of $1 million. These funds generally come from venture capital firms and may have angel syndicates and equity crowdfunding platforms participating. The first round of funding at this stage is referred to as Series A funding. Additional rounds of funding for a company continuing to expand are referred to as Series B, Series C and so on.

This funding typically enables the founders to recruit key team members, undertake further development of the product or service and execute a more comprehensive marketing campaign designed to scale up customer acquisition, brand awareness and revenue.

Issues founders should consider for a successful equity capital raise

Raising capital for a business is a competitive process. Most investors are presented with opportunities on a daily basis, so it is important that the business, the team and the operation will withstand scrutiny.

- Founders need to be able to **articulate the consumer problem** they are solving or opportunity they are targeting, the likely size of the market, how their solution addresses the problem or opportunity better than the competition, what strategies they have in place to acquire market share and why their team is best placed to execute their strategy. In short, founders need to **know and sell their story**.

- Founders need to **show proof of validation** by obtaining significant user traction or customer revenue. This will assist in showing that the problem a business is trying to solve is important to a significant segment of the target consumers and most importantly that those consumers are prepared to pay for the solution.

- It is also essential to **ensure the corporate and legal affairs of the business are in order**. Having these things in place adds credibility to the founding team and helps increase the chances of a successful capital raise.

- Another key aspect of being investor ready, especially if the business is targeting venture capital investment, is being able to **assess whether the business is ready for a venture capital investment**. It is important for founders to understand the mechanics of how venture capital works. One of the key criteria that venture capital investors seek are businesses with strong ambitions for growth. Typically, a venture capital investor would not consider any business that has less than a potential of a multiple of ten times return on their investment.

Key issues associated with equity capital raise

Capital raise amount

The first issue to be determined by the board is the amount of capital to be raised.

The amount should reflect the forecast capital expenditure of the company for the next 12 – 18 months and be attached to measurable milestones that are expected to increase the value of the company's equity.

Often the capital being raised is earmarked for the hire of additional team members, further product development, customer acquisition and sales and marketing initiatives. Investors will want to understand these initiatives in some detail and be convinced that they are a wise use of the capital raised.

Once the business has decided on how much capital is required, it will also be important to make a decision about how much equity in the company the business is prepared to exchange for that capital. The founders should also have an understanding about what type of equity, for example ordinary shares or preference shares. This is where a valuation of the company will be required.

Valuation

Valuation of early stage companies is an art rather than a science. It is the product of a combination of factors including existing market traction, the size of the opportunity, the quality of the management team, the strength of the competition, the existence of barriers to entry (including intellectual property that is registrable) and relative values of comparable companies.

Assumptions play a vital role in the development of a realistic and robust valuation model. Analysts and investors are likely to analyse these assumptions in the context of public information, comparable companies and market intel. The more these assumptions align with these parameters, the greater confidence investors are likely to place on the estimated valuation.

Regardless, the valuation for early stage companies is highly sceptical and should be updated frequently as early stage growth is unpredictable.

Understanding investor expectations around valuation early on is vital to ensuring founders do not alienate investors with unrealistic valuation expectations.

Intellectual property

Intellectual property is often a start-up’s key asset. This is becoming increasingly so with technology centric businesses or those that rely on technology delivery platforms i.e. most start-ups!

During the early years, it is not unusual for a number of people to have contributed to the business’ intellectual property (including through open source software or similar) or for ownership in intellectual property to be unclear.

A relaxed approach can leave founders exposed to potential disputes by third parties and other co-founders, which can compromise the company’s growth plans. It can also compromise the valuation of a company as it seeks to raise funds.

Investors will expect that intellectual property rights are owned by the corporate entity seeking the funding or that key intellectual property rights have been properly secured. There are various ways in which intellectual property can be protected and early advice is critical.

It is important, regardless of the size or type of work that any third party is undertaking, that these arrangements are documented and there are clear provisions providing that ownership of intellectual property will vest in the corporate entity or appropriate licences are in place. Technology start-ups that rely on copyright protection for their software need to be particularly careful here, given there is no ‘registration’, and ownership will often turn on the appropriate assignment of rights.

If the contribution of intellectual property is part of a party's investment, then venture capital investors may seek to link the provision and support the intellectual property to the equity holding (or require a way to ‘step-in’ to preserve the business if ongoing support is not provided). Again, this just reinforces the value of appropriate intellectual property protection.

Corporate structure

Investors will also require an appropriate corporate structure be in place. This structure should ensure that any undocumented arrangements regarding equity have been addressed (often this is equity promised to key team members), the intellectual property and any other key assets are held by the correct entity, that asset protection has been considered and that the structure allows for the future expansion of the business or the potential sale or listing of the business.

Existing shareholder rights

A fundraising process is often as much an exercise in stakeholder management as it is a showcase for new investors.

Introducing new shareholders to a company can change its culture, potentially dilute existing shareholders and alter its management dynamics. Therefore, it is important that existing shareholders are aligned with the capital raise strategy before approaching external investors. The company's constitution and shareholders' agreement should also be consulted to ensure the rights of existing shareholders are understood and addressed.

The more complicated your member register, the more time you will need to dedicate to this kind of stakeholder management. Without the support of existing shareholders, the capital raise program can be unnecessarily delayed or frustrated.

Fundraising rules

The *Corporations Act 2001 (Cth)* requires disclosure to investors when an offer of securities for issue is made, unless an exemption applies (including with respect to 'sophisticated' investors, which may be relevant where start-ups are engaging with either angel investors or venture capital or pursuant to the new crowd-sourced funding regime applicable to unlisted public companies due to take effect in September 2017). If disclosure is required, this is generally made by way of a prospectus, a short form prospectus or an offer information statement. Each type of disclosure document requires varying levels of regulated content.

It is important that the founders understand the fundraising rules and the available exemptions to ensure the fundraising campaign does not contravene the legislation.

Crowd-sourced Funding and the Corporations Amendments (Crowd-sourced Funding) Act 2017

On 28 March 2017, the *Corporations Amendments (Crowd-sourced Funding) Act 2017* (CSF Act) received royal assent with the provisions to take effect from 29 September 2017.

The approval of this legislation has had a protracted history including lengthy debate as to whether the legislation provides an appropriate framework for this type of alternative funding, given that at this stage it will only be available to unlisted public companies, with proprietary companies having to change to a public company in order to be eligible to undertake crowd-source funding.

In response to the market's reaction to the CSF Act, the Federal Government announced in this year's Federal budget, its plan to extend crowd-sourced funding to proprietary companies. Following the budget, Treasury released draft legislation and the associated explanatory memorandum for public consultation, seeking to further amend the *Corporations Act 2001 (Cth)* and CSF Act to extend crowd-sourced funding to proprietary companies. Submissions for the public consultation process closed on 6 June 2017. Timing on the implementation of the extension of the legislation to proprietary companies is yet to be announced.

Founding shareholder debt

Seed stage funding contributed by the founders is often provided to the business in the form of shareholder loans. Investors at this stage will generally not permit shareholder loans to be paid out of any future funds raised and will expect any shareholder loans to be converted into equity or forgiven prior to any fundraising.

Research & Development Tax Incentive

The Research and Development (R&D) Tax Incentive provides a key opportunity to fund ongoing development and increase cash flows within the business, as well as leveraging the equity capital raised from private investors.

For companies with turnover of less than $20 million, this program provides up to 43.5 cents cash back for every $1 spent on eligible R&D activities, thus benefitting emerging companies the most (particularly those pre-revenue where tax losses are likely to be available). The process is self-assessment and non-discriminatory in regards to industry, with claims lodged on a yearly basis to access annual refunds.

Investors will expect that companies have maximised the opportunities available to them under the R&D Tax Incentive program and have utilised the additional cash available to their advantage.

Companies who are accessing the refundable R&D offset can debt-finance their R&D activities through the income year. Financiers lend up to 90% of the 43.5% amount which is paid back to the financier once the R&D refund is paid, at the end of the income year, following the ITR process.

Asia-Pacific

Similar capital raising considerations will apply to start-ups from across Asia Pacific, a region which has seen over $100 billion of venture capital funding invested into over 5,000 high growth companies since 2012[1].

Alternative sources of financing, such as equity crowdfunding and venture debt, are becoming increasingly available across the region. However, local laws and market conditions vary significantly from country to country, and founders must proceed with caution when deciding where and when to expand their businesses beyond their home markets.

PwC's Emerging Companies and Venture Capital Team

PwC's Emerging Companies and Venture Capital team uniquely comprises lawyers (full service, including Corporate and Technology), accountants (including CFO function and audit), tax advisers, R&D consultants, deals and valuations specialists, in Australia, the Asia Pacific region and throughout the globe through the PwC Network firms.

We also act for some of Australia's most prominent venture capital fund managers, equity crowdfunding platforms and angel groups, so we understand how early stage investors think and can help founders navigate investor demands.

We work with venture capital investors and emerging companies in which they invest every day to help negotiate and close early stage funding transactions efficiently.

Our scope and fees are designed to fit an early stage company budget and cash flow.

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[1] "Startup Continent: The Most Well-Funded Tech Startups In Asia & The Pacific", published by www.cbinsights.com, 24 March 2017.

The takeaway

To ensure a capital raise stands the best chance of success, the business and founders need to be prepared.

Every early stage capital raise is different, so founders need to understand what stage of development their business has reached, and take steps to ensure they are 'investor ready'. To ensure that founders maximise the future value of their shareholding, it is important to understand how equity and debt deal structuring works, and the related impact on their equity, returns and control.

A successful capital raise program has the potential to secure not only capital for growth, but also attract strategic investors and partners who can help position the company for the opportunities that lie ahead.

For more information or to discuss a proposed capital raise, please contact the PwC Emerging Companies and Venture Capital team.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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