

## Funding Strategies That Work

By Christina Ellwood, Moreland Associates

Successful entrepreneurs and investors addressed the topic "**All Cash is Green: but Not All Funding Sources are Created Equal**" at a recent SVASE (see panelist names and bios below). The panelists discussed the trade offs of raising money from angels, VCs, private equity (PE), corporate strategic investors, and debt. They also offered their thoughts on other financing related issues including cap tables, choosing among investors and advisors, as well as on valuations. Here's a re-cap of their comments.

### Self-Funding

Both Kendall Fargo and Mike Simmons used their own capital to fund the initial phase of their respective companies and only raised outside capital after having achieved substantial milestones and value. Fargo advised entrepreneurs to "fund as long as possible yourself." He went on to say "I suggest you build a great business and then you'll have options." Personal funds, loans from friends and family, second mortgages and credit cards are all methods of self-funding.

### Angels

Angel investors are a good source when more substantial amounts of funding are required, typically between \$25K and \$1M. The panel thought highly of angels and all three entrepreneurs turned to them to fund their current companies. Greg McAdoo from Sequoia Capital noted "about 25% of our investments got angel funding in advance of our investment in 2005. We view angels as an important part of the ecosystem. Bridge financing is a good way to bring in this type of early money before the share price is set." McAdoo commented that some VCs, including Sequoia Capital, make seed-stage investments. Without identified market demand for a company's product or service, however, he suggested working with an angel who has relevant domain expertise to help validate the market. Regarding structure, he recommends using a convertible note tied to a future institutional round rather taking the money as an equity round.

There was consensus that keeping the number of angel investors down is a good idea. While specific numbers were not given, 20 was considered too many. Be careful not to let the cap table get inflated to the point where it will be necessary to re-capitalize to complete the first round of institutional funding. Focus on high quality angel investors – whether an individual or a group. Choose investors who can provide substantial help reaching the next milestone with their domain knowledge and contacts.

As with all types of investors, a warm introduction will pave the way with the angel. So, find someone who knows them – don't just email your business plan. Request introductions to angels, from your advisors including your attorney, accountant, and other professionals working with the company.

## Venture Capital

Venture capital (VC) investors bring a unique combination of capital, experience with early-stage operations, and technical domain knowledge. Some even bring operational experience to the table. A form of PE, venture capital tends to flow to early stage companies, whereas traditional PE firms focus on later stage companies, typically with revenue and profits (or close to achieving profitability).

As a company matures and requires more substantial funds, it becomes more appropriate to approach a venture capital or PE firm. Since the competition for their attention is high and their filters are highly refined, the canny entrepreneur finds a trusted party to make an introduction. If you want to approach a firm, but you don't know someone there, find someone who does. Ask your attorney, accountant, banker, consultants, and advisors. Highlighting the importance of an introduction, McAdoo explained that the partners at Sequoia Capital, a tier one VC, read 6,000 business plans in 2005. They held 1,500 meetings with the entrepreneurs and had only 150 companies present to the partnership. They subsequently invested in only 20 companies. To him, trusted referral sources are an important first screen.

There may be times when two or more investors may come together to fund the round. In some deals, having two investors doubles the expertise brought to the company. In others, the sheer size of investment required may be too large for one investor. For example, systems companies (offering integrated hardware and software) typically need \$50M-\$60M of venture funding over time. This is generally too large for a single fund. Putting together the syndicate requires the right chemistry. McAdoo describes the process as "a bit like looking for a job. At first you're selling, but as you get closer to the offer, you become a buyer. Check out your potential partners." Ideal investors will bring a willing attitude to their board responsibilities – ears open, gently offer help, will take action, follow through, be engaged, and show up.

## Private Equity

PE firms do sometimes invest in early-stage start-ups, particularly when their traditional market of operational company investments gets crowded. It was noted that PE investors can pose some challenges for early stage companies. The PE investor's skills in financial engineering can lead them to requesting creative preferences which then get in the way in subsequent rounds. In addition, they are used to serving on the boards of later stage operating companies and are not accustomed to the issues of early stage companies and the "roll up your sleeves" involvement required.

## Corporate Venture/Strategic Investments

Some corporations have venture funds used for making strategic investments. These investors typically come in after a lead investor, most often a VC, has set the terms. David Hartford noted "Corporate venture groups are more volatile." Their strategy can change especially in a downturn. So, when you need to go back to the well, they may say "oh, we're not investing there anymore".

### Customer and Channel Funding:

Once you have a product offering, it can be valuable to look for situations where your customers can provide funding through pre-orders, Non-recurring engineering (NRE) funds for accelerated delivery or the development of special features. Also consider

licensing your product for sale in regions or niche markets that you can't reach anytime soon (or ever). Hartford mentioned a case where "we knew our product would sell well in Japan but we couldn't afford to operate there anytime soon. So, we sold a license for \$2M."

## Debt

Debt can take many forms. Used appropriately, it can be a valuable financing tool for the entrepreneur. In addition to bridge funding previously discussed, vendor financing is a great way to finance the software licenses and equipment start-ups often require. Lease-lines, working capital lines, subordinated debt, and other such instruments can also be used to finance equipment and short-term working capital. Financing to build enterprise value, through activities such as R&D, has traditionally taken the form of equity. Today, hybrid debt financing vehicles, such as growth capital, are also available in select cases. Small Business Administration (SBA) loans are an option but may require a personal guaranty.

## Grants

One source of funding not discussed was government grants. Small Business Incentive Research (SBIR) grants are but one type of grant offered by the US Federal government. Information about available SBIR and other government grants can be found on the SBA website.

## Due Diligence

There is no standard for due diligence by any type of investor. It can take hours or months. Simmons mentioned that they hold a large number of patents and they have had investors bring in technical experts to conduct due diligence on the technology in addition to the business due diligence.

## Valuations

McAdoo explained that nine times out of ten, valuations are determined by the combination of the amount of money the company naturally needs to raise and the amount of the investor needs to own. For example, if the company needs \$5M and the investor needs to own 50%, then the valuation is set at \$5M. Competitive pressure can affect the valuation as can the reality of the cap table. For example, if you need to leave room for a later stage investor, the pre-money valuation may be set a bit higher. In general, valuations have been going up lately where there had been some compression. Right now there are firms who have been sitting on the sidelines who need to get the money put to work to satisfy their investors (and to earn their management fees) so, this may artificially drives up valuations.

## Summary

A variety of funding options are available and each brings its own value. Consider self-funding, SBIR grant, and/or Angel investments in the early days to reach a point where the value can be demonstrated. Then, look to VC funding. After the initial VC round, consider strategic investors, PE, vendor financing, customer funding and debt as possible sources for funding.

## Panel Moderator

**Chris Stedman, Silicon Valley Bank ([svbank.com](http://svbank.com))** - senior vice president and division manager of Silicon Valley Bank's South Bay region, located in the heart of Silicon Valley. He is responsible for all commercial banking activity in Northern California's South Bay region and has served in this position since May 2004.

## Panelists

**Greg McAdoo - Partner, Sequoia Capital ([sequoiacap.com](http://sequoiacap.com))** - Greg McAdoo focuses on investments in the components and systems sectors and joined Sequoia Capital in 2000. He is currently Director of PowerFile, IP3 Networks, Big Bear Networks, & Isilon Systems. Greg was also responsible for Sequoia's investment in Allegro Systems (Acquired by Cisco in 2001). Formerly President and CEO of Sentient Networks (Acquired by Cisco Systems), Greg has over 17 years of engineering and management experience in the networking industry. Greg has held senior engineering and executive level management positions at Cisco Systems, Sourcecom, Micom Communications and Datability Systems.

**Mike Simmons** - Chariman and CEO, ORBID Corporation ([orbidcorp.com](http://orbidcorp.com)) – Mike joined ORBID at its inception in August 2002. Prior to joining ORBID he served as the President of VIA NET.WORKS, Inc.; Managing Director of United Pan-Europe Communications; Vice President-Marketing for A2000, the UPC and MEDIA ONE joint venture in Amsterdam; GM in Ft. Wayne, IN and then AVP in New Jersey for Comcast Cable Communications; and marketing, sales and operating positions with Insight Communications Company, Inc. and Westinghouse Broadcasting and Cable.

**David Hartford** - Founder and board member, N8 Systems ([n8systems.com](http://n8systems.com)) - David was the founding CEO of N8 Systems from January 2002 to November 2005. He has more than 25 years of experience with software development--as a software/systems engineer and manager for large-scale systems development (Mellon, Rockwell International), an attorney representing software companies (Brobeck), and an investor in software and systems integration companies (Technology Funding, European Convergence Partners).

**Kendall Fargo** - Founder and CEO, StepUp Commerce ([stepup.com](http://stepup.com)) - Kendall Fargo is the Founder and CEO of StepUp Commerce, Inc. StepUp is a leading local shopping services company that helps retailers use the Internet to display their in-store products. Prior to founding StepUp, Kendall was the VP of Internet and Enterprise Business at Handspring, Inc. and oversaw the company's e-commerce and retail channel business. Prior to joining Handspring, Kendall was co-founder and Vice President, of Corporate Operations at Beyond.com.

copyright © 2006 moreland associates.

Readers are authorized to reproduce and distribute copies of this article in its entirety so long as credit is given to Moreland Associates and our contact information is provided. To subscribe to tractionNOW! go to [www.morelandassoc.com](http://www.morelandassoc.com)

2532 santa clara ave, #413, alameda, CA 94501 510-748-8146