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[Funding Strategies That Work](#) [By Christina Ellwood](#)

Successful entrepreneurs and investors addressed the topic "**All Cash is Green: but Not All Funding Sources are Created Equal**" at a recent SVASE [panel](#). 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

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Building the Breakout Company

Building the Breakout Company

Moderator:

Kevin Matsushita
Silicon Valley Bank

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

Panelists:

Gadi Behar,
Silicom Ventures
Howard Hartenbaum,
Draper Richards L.P.

Jim Marshall,
Selby Ventures
Greg McAdoo,
Sequoia Capital

Ron Star, Howard Rice
Nemerovski Canady
Falk & Rabkin

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PANEL QUOTES

"About 25% of our investments got angel funding in advance. We view angels as an important part of the ecosystem. Bridge financing is a good way to bring in early money before the share price is set." - **Greg McAdoo, Partner, Sequoia Capital**

PANEL QUOTES

"Have a plan and stick with it. Assume you'll need to raise twice as much as you think you'll need and it will

(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,

take you 2-3 times as long as it's supposed to." - **Mike Simmons - Chairman & CEO, ORBID Corp.**

"Assign some mental value to the quality of the potential investor. S/he should know your space, have a strong Rolodex, be able to help with customers and management. A good question to ask you VC - "Just how active are you going to be?" - **David Hartford - Founder and board member, N8 Systems**

"Fund as long as possible yourself. I suggest you build a great business and then you'll have options. If you think you'll need 2 investors, get 4-5 interested. This will ensure the highest/fairest valuation, cut down on due diligence, and let you pick the investor you feel brings the most value." - **Kendall Fargo - Founder and CEO, StepUp Commerce**

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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.

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Leveraging Debt to Extend Your Runway by Kevin Matsushita

VP, Emerging Technology Practice, Silicon Valley Bank

Today, investors expect more of entrepreneurs than astute strategic management and operational excellence in building successful companies. Investors expect capital efficiency. As a result, entrepreneurs often turn to debt as a critical component of the capital structure and should be mindful of its potential use throughout a company's life cycle.

Debt financing has evolved considerably from a capitalization vehicle purely for mature, profitable companies. Debt can be a fitting complement to equity and extend the "runway" a round of equity provides. Even in the early stages when a company is building enterprise value through R&D, debt can help finance hard assets such as equipment and working capital, and even serve as a source of growth capital that can finance general corporate purposes. At the same time, it can help the entrepreneur increase the company's valuation and reduce dilution in the subsequent round of equity. Debt enhances the return on equity for the investor and lowers the overall cost of capital for the entrepreneur.

While early stage debt financing is typically available to a company that has raised money from institutional investors, pre-venture funded companies are not excluded from using debt. Working capital financing is available to revenue stage companies that may not have raised venture capital. Lenders can provide lines of credit and make advances against eligible accounts receivable and/or inventory in some cases. This type of financing also serves to help build value, reduce dilutive effects of equity, and lower the company's weighted average cost of capital.

It is important to be mindful of the differences between debt and equity and the similarities in the capital raising process. Generally speaking, lenders have a priority claim on assets, whereas equity investors do not. To compensate the investor for their higher risk position, the cost of equity is higher. Higher risk equals higher cost of capital. The importance of an entrepreneur's due diligence in raising debt or equity is the same, however. Just as an investor or lender performs due diligence to evaluate a company, so too must an entrepreneur make its own evaluation of the investor or lender.

Particularly important in the case of debt is to work with a lender capable of providing debt financing vehicles

throughout all stages of development. Remember, higher risk equals higher cost. As a company progresses into commercialization, for example, risk is reduced and options for less expensive debt arise. To take advantage of this, an entrepreneur may want to consider a lender that can provide these options. In the end, an entrepreneur should work with a firm that adds value to his or her company, has domain experience in working with companies like theirs, and has a strong reputation in the industry for supporting companies through challenging times.

Next Issue - The Power of Advisory Boards

An Advisory Board is a non-governing group of advisors who provide advice and make introductions. They supplement the role of the governing Board of Directors.

An Advisory Board can help establish credibility, open doors with warm introductions, provide insight on strategy, help you avoid pit-falls, and help you meet short-term objectives. For young, unproven companies these contributions are worth their weight in gold.

Many companies set-up Technical, Business and/or Customer Advisory boards and then don't take full advantage of them. Experienced entrepreneurs and advisors know how to tap into the wisdom and Rolodex of their advisors to help them succeed.

The next SVASE East Bay Series event will explore this topic and we'll report on it in the next issue of TractionNOW!

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