Morgan Lewis

EMERGING BUSINESS FINANCING:

EARLY STAGE INVESTMENT

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The Life of a Startup

- Many startups attempt to follow a fairly well-defined path that includes the following stages:

  - **Idea (bootstrapping):** all startups begin with an idea, which the prospective founders build on by creating sketches/mockups/prototypes, etc. so that they can solicit feedback from trusted friends, family, advisors and potential customers.
  - **Minimum viable product (MVP) (seed stage of development):** the next step is to build a basic version of the product that has just enough functionality to allow the founders to test market reaction as cheaply as possible.
  - **Building (Series A financing):** if the MVP is validated by the market, founders must then raise sufficient capital build a more substantial version of the product to be released to a broader audience, and perhaps to hire additional employees.
  - **Scaling (Series B financing and beyond):** once a startup has created a scalable version of its product, its focus shifts to rapidly expanding its customer base to capture as large a portion of the product's addressable market as possible.
  - **Maturity and exit (liquidity events):** as the startup grows and matures, its focus turns from maximizing revenue to attaining profitability—however, startups are often sold long before profitability is realized.

Seed Stage of Development

- At the beginning of the typical startup's lifecycle, prospective startup founders are usually **bootstrapping** the company. This means they are **moonlighting** and spending their own money (or small amounts of informally-borrowed money from friends and family) to develop their idea before raising an outside round of capital. Many founders raise **seed capital** so that they can:
  - Quit their day jobs and focus on their startup full time.
  - If they lack technical skills, hire contracted developers to create a first functional iteration of their concept.
- Startups may raise multiple rounds of debt and equity seed capital before they can successfully complete a **Series A financing** led by an institutional **venture capital** (VC) fund.

Types of Seed Investors

Friends and Family

- The personal networks of a startup's founders typically serve as an important source of seed capital in early stage financing rounds. Since these rounds consist primarily of close friends and family of the founders, they are often referred to as **friends and family rounds**.
- Startups take “seed” investments from these individuals. Startup founders also often ask these individuals to serve as informal or formal advisers to the company.
- Founders also often tap into their professional networks to find contacts in the industry in which their startup plans to compete. These industry contacts can be useful sources of seed capital, and also advice and relationships (such as relationships with other potential investors, employees and customers).

Types of Seed Investors

Angels

- It is usually a good sign if seed-stage companies are able to find high-net-worth individuals outside of their founders' personal networks who are willing to invest small portions of their wealth in risky startup ventures. These investors are known as **angels**.
- In recent years, many angels have formed collaborative angel networks that share information about potential investments, investing strategies, and promising entrepreneurs.
- When founders can interest one angel investor in their startup, that angel often convinces several of his or her high-net-worth friends or contacts from an angel network to invest as well.
- These angel networks often have a geographic focus. Members bring different strengths to the table, and also share responsibility for board participation and oversight.

Types of Seed Investors
Super-Angels

- Angel investors who are full-time investors in early stage companies and well-known in the startup community are sometimes referred to as **super-angels**.
  - Super-angels often create their own investment funds to invest in startups.
  - Super-angels can often invest larger amounts at an earlier stage.
- These funds typically include the super-angel's own cash, as well as money contributed by contacts from his or her personal network.
- Super-angels can be as sophisticated as institutional VC investors, but they tend to invest in a larger number of companies and in much smaller amounts. Their vetting process can be far more extensive than small angel investors.

Seed Stage of Development
Amount Raised

- Startups raising seed capital tend to raise anywhere between **$50,000** and **$1 million** in one or more rounds of financing.
- It is not unusual for a startup to live "hand-to-mouth"—essentially conducting a continuous offering.
- Some seed rounds are slightly larger, but they are almost always less than **$3 million**. A financing of **$3 million** or greater would more likely be considered a Series A financing instead of a seed round.
- In a seed round where the company raises **$1 million** or more, a startup often issues <u>equity securities</u> (namely **Series Seed preferred stock**), as opposed to <u>non-equity securities</u> such as **convertible notes** or **simple agreements for future equity** (SAFEs).

Seed Stage of Development

Number of Investors

- The number of investors who participate in a seed financing round can vary widely. Seed investors tend to invest in smaller amounts individually (from $10,000 to $50,000 is common).
- **Therefore, a company may need to accept investments from dozens of seed investors to reach a target of $1 million for the total size of the round.** Such a financing structure can lead to potentially problematic legal and operational issues down the road.
- Since the logistics of corralling so many investors into a single closing may be a daunting task for founders, startups often engineer their seed rounds to have multiple (or rolling) closings over an extended period of time. Founders also use technology—such as *docusign*—to manage these rounds.
- If some investors cannot participate in the initial closing or if the startup finds more willing investors later, the company can schedule additional closings in the weeks, and sometimes months, that follow.

Types of Seed Financing Instruments

Common Stock

- **Common stock** is the simplest form of equity investment. Investors who purchase shares of common stock typically receive the same security that the startup's founders hold. Common stockholders generally have the right to:
  - Vote for the company's board of directors and on other stockholder matters.
  - Receive dividends, if and when declared by the board.
  - Receive their proportional share of the company's remaining assets if the company is liquidated.
- However, they do not usually have the additional rights, preferences, or privileges the company's preferred stockholders (or noteholders and SAFE holders, following the conversion of those instruments) receive.
- Because founders typically issue common stock to themselves for a very low price per share, it can be difficult to justify a substantially higher price to investors. Also, high-priced common stock can cause problems with stock option pricing.

Types of Seed Financing Instruments

Convertible Preferred Stock

- It is still somewhat common for seed investors to purchase convertible **preferred stock**. Preferred stock issued in a seed round is often designated **Series Seed preferred stock**.
- Series Seed preferred stock includes most of the same rights, preferences, and privileges that are usually included in **Series A preferred stock**. Series Seed rounds frequently do not include some of the more mechanically burdensome provisions that are fairly standard in a Series A financing.
- Series Seed financing documents often <u>do not include</u> some or all of the following terms:
  - **Registration rights.**
  - Rights of **first refusal** and **co-sale**.
  - Price-based **anti-dilution provisions**.
  - **Drag-along rights**.

Types of Seed Financing Instruments

Convertible Notes

- Convertible notes are the most frequently used instrument for raising modest amounts of capital at the seed stage. They are **debt securities** that have the following key terms:
    1. Principal amounts that are due at a maturity date.
    2. A fixed rate at which **interest** accrues on the principal balance.
    3. A claim on the company's assets that is senior to all equity holders.
- The goal of an investment in convertible notes is to convert them into the same preferred equity security the startup issues to its first institutional VC investor in the company's Series A round, rather than to receive their principal-plus-interest at maturity.
- Therefore, investors typically view the conversion features as the most important provisions in a convertible-note deal, as they are the mechanisms by which the noteholders eventually become stockholders of the company.

Types of Seed Financing Instruments
Convertible Notes – Conversion Events

- Next **Equity Financing conversion:** In this scenario, the principal and interest of each note converts at the relevant conversion price into shares of the same series of preferred stock that the new equity investor purchases in a later financing round. *Setting a minimum size for a qualifying preferred round is important.*

- **Corporate Transaction conversion:** If the company is sold while the notes are still outstanding, investors may:
  - Elect to have their principal and accrued interest (or perhaps the interest plus some multiple of the principal) repaid; or
  - Convert the balance of their notes into shares of common stock at a discount to the price in the acquisition.

- **Maturity conversion:** If the company reaches the maturity date without having triggered a Next Equity Financing conversion or a Corporate Transaction conversion, convertible notes often give investors the option to:
  - Convert their notes into shares of common stock at a predetermined price; or
  - Leave the notes outstanding.

Types of Seed Financing Instruments

Convertible Notes – Conversion Price

- When a **conversion event** occurs, convertible noteholders receive equity based on the principal and interest balance of their promissory notes, but at a price that is lower than the price paid by the new equity investors. The lower price the noteholders pay is calculated based on either a:
  - **Discount rate** (often 20%); or
  - **Valuation cap.** Convertible notes often contain a ceiling, or cap, on the **pre-money valuation** at which the notes may convert into stock in a Next Equity Financing to ensure that the noteholders own at least a certain amount of the company upon conversion.
  - It is important to provide that the terms of the convertible notes can be amended with the approval of the company and the holders of a majority of the outstanding principal amount of all notes.

Types of Seed Financing Instruments

SAFEs

- The **SAFE** (“Simple Agreement for Future Equity”) has become an alternative to issuing convertible notes when a company is reluctant to issue debt for fear of reaching the maturity date before concluding a Next Equity Financing. In this scenario, the founders generally negotiate an extension with the noteholders, who may try to extract better terms in exchange for their consent. The SAFE has all of the same conversion features of convertible notes but lacks certain hallmarks of debt. In particular, a SAFE has **<u>no</u>**:
  - **Maturity date.** Until a conversion event occurs, the SAFE remains outstanding indefinitely.
  - **Accruing interest.** Investors receive only a right to convert the SAFE into equity at a lower price than the investors in the subsequent financing (based either on the discount or valuation cap in the SAFE).
- Recently, some seed investors have been increasingly willing to invest in SAFEs instead of convertible notes. This may be particularly true for "hot" startups, such as those that are admitted to **Y Combinator's** “accelerator” program. Many seed investors recognize that if the startup does not raise more money, they will never be repaid anyway. However, many investors still refuse to invest in SAFEs.

Choosing the Right Seed Instrument

- Choosing the seed instrument that best fits a given startup's needs usually turns on a combination of the following factors:
  - **Investor sophistication:** less experienced investors may not be experienced in or comfortable with negotiating all of the terms typical of more complex seed financing instruments.
  - **Investor preference:** founders of early stage startups generally want to minimize adversarial negotiation and conflict with their seed investors.
  - **Cost vs. amount raised:** the choice to use a complex financing instrument (which often involves considerable legal fees) is often directly correlated with the amount raised in the financing round (meaning the greater the size of the investment, the more reasonable the choice to use a complex financing instrument becomes).
  - **Time:** in general, the more complex the financing instrument, the longer it takes to document and close the financing round. Startups typically have a preference for simpler instruments that require less negotiation in seed-stage deals.

Helpful Resources

NATIONAL VENTURE CAPITAL ASSOCIATION

PitchBook
Better Data. Better Decisions.

ACA
ANGEL CAPITAL ASSOCIATION

CB INSIGHTS

Practical Law™ A THOMSON REUTERS LEGAL SOLUTION

TechCrunch

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Benjamin David Novak represents emerging growth companies, as well as the private equity and venture capital funds that finance them. He advises clients on corporate matters such as entity formation, corporate governance, securities, equity financings, debt financings, and mergers and acquisitions. Prior to joining Morgan Lewis, Ben was an associate in the venture capital and technology practice of a prominent national law firm. In addition to his law practice, Ben is an active angel investor.

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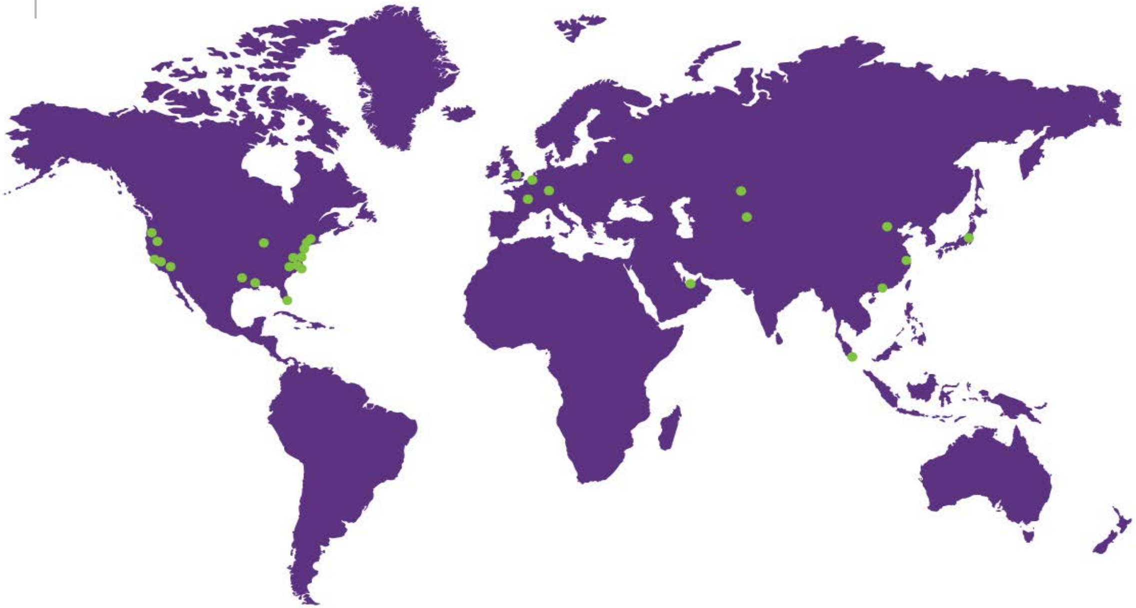
Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Almaty
Astana
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore
Tokyo
Washington, DC
Wilmington



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