BEYOND VC: ALTERNATIVE FINANCING FOR STARTUPS THAT WANT TO GROW WITHOUT GIVING UP CONTROL

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Lighter Capital

It's exceedingly rare for a startup to succeed without at least *some* outside funding. Building a company is an incredibly challenging and costly endeavor, and founders almost always need a boost—even if only from friends and family. More often than not, they want to raise venture capital.

The VC industry, for its part, has done a tremendous job of encouraging this aspirational narrative. Hollywood productions including *The Social Network, Jobs,* and HBO's *Silicon Valley* have taken this narrative out of finance industry obscurity and into popular culture. And what entrepreneur doesn't romanticize following in the footsteps of Musk or Bezos?

Yet here's the reality: in the world today, there are approximately 200 unicorns (startups worth $1 billion or more) and more than 900,000 tech startups in the U.S., according to census data. That means that less than 1/50th of 1 percent of startups ever reach the upper echelons of success. For fun contrast, your chances of founding a unicorn are just slightly better than your chances of being struck by lightning.

Worse, most founders of those unicorns give up huge chunks of equity to achieve that scale. For example, the founder equity stakes of Yelp, Trulia, and Hubspot were worth only about $10 million each at IPO and founder equity stakes in TrueCar, Box, and ZenDesk were only worth about $9 million each at IPO. That's a collective $57 million in founder equity for a collective market cap of $5.9 billion at the time of IPO, or less than 1 percent of total. A wonderful reward for all of that hard work, no?

There *are* ways to achieve your growth goals without giving away half (or more) of your company. You *can* control your destiny, achieve financial independence, and build something wonderful for your employees and customers. You *can* build a great business, on your own terms and at your own pace. Over the next few sections, we'll discuss alternative funding methods to help you achieve your dream and keep the fruits of your labor.

IS VC ALL IT'S CRACKED UP TO BE?

Let's examine VCs for a moment. When you agree to take that hefty, multimillion-dollar check, you also agree give up a heart-stopping 20 to 50 percent of your

business, form an official board, and cede a lot of control. After all, they can now fire you from your own company.

Venture capital does make sense for businesses that are on track to become the next AirBnB or Uber. However, if you sympathize with any of the following considerations, then VC may not be the right fit for you:

- You don't want to give up 20 to 50 percent of your business.
- You don't want to manage a board of directors.
- You don't want to have others voting on how you should run your business.
- You don't want the pressure to reach certain milestones or exit by a certain year.
- You don't want to take six to nine months of time to fundraise every other year.
- You're okay with your startup not becoming a multi-billion dollar business

WHAT YOUR FINANCING OPTIONS LOOK LIKE

There's been a lot of talk about the "bubble," but it's more like the dust settling. There have been some very high valuations in recent years, and now it's becoming even harder for startups to attract and earn VC. VCs are becoming more risk averse and are sticking to safer deals with tried-and-true models, which leaves a lot of great ideas unfunded. VC aside, here are a few alternative financing options to fund your venture.

> **Important note:** Double check the *moonlighting clause* in your employment contract before you do any work on your new business on the side. Many companies have strict rules and can end up owning the intellectual property in your new venture if you do side work on company time or using company resources such as a work laptop, for example. You should always talk to a lawyer before getting started, just to be safe.

REVENUE

Most startups fail because they don't make revenue a priority or they can't earn revenue. Your idea doesn't make the leap to a real business until you have paying customers. Before that, it's still just an idea.

While there are certainly many valid reasons for why you might need to raise investment at the onset of the startup journey—engineering or physical manufacturing for example—you should still be able to find at least one paying customer for your idea *before* you write the first line of code or build the first prototype. Find the people who have such a burning need for your solution that they're willing to prepay for the product, sight unseen.

You should spend most of your time in the first 6 to 12 months of your startup journey talking to potential customers—which can often be done before you quit your current job, saving you critical cash resources until you're absolutely sure you're ready to quit and launch a new business. This effort will strengthen your understanding of the market dynamics, competitors, critical customer needs, and sales and marketing costs—all critical factors in business success.

Remember, a business exists to deliver value to people in exchange for money. If you can't find at least one customer to prepay, that's a big red flag. It means that you haven't yet identified the key set of features needed to be competitive in the market, or you haven't found the right customers or the right market.

If you have revenue, you've successfully solved a problem for someone, and revenue is the best kind of investment for a startup. That's the whole point of the game.

FRIENDS AND FAMILY MONEY

Nearly every business in America—from restaurants, to dry cleaners, to many tech startups—got some of their early funding from a friend or family member. This source of funding is the bedrock of what makes American

entrepreneurialism possible. From Donald Trump to Bill Gates, American business is filled with entrepreneurs who took a check from their parents and then took a chance on building something great.

The upside of friends and family funding is that it's easily accessible in a safe and welcoming environment. When Aunt Jane cuts you a check, you know she wants to see you succeed.

Yet, there are three major downsides to taking money from Aunt Jane. First, she likely doesn't have enough money to give you all the resources you need. Which means you also need to get checks from Uncle Joe, neighbor Bob, and your college buddies Jennifer and Shameek to fill out the round. While not immediately apparent, you've just taken on more work than you realize. Each of these friends and family members—correction: *new investors*—will want to be kept in the loop. They may want to know how you're spending your money, the ins and outs of your go-to-market strategy, who you're hiring first. They may ask you to justify your use of funds. It doesn't matter whether one has put in $50,000 and another just $2,000. These friends and family are betting their savings on you and you owe it to them to claw your way to the top. Along the way, you'll likely be hearing quite a bit of advice from these new investors, regardless of their business background or industry expertise. This always ends up being a major distraction for startup operators and it adds stress to an already incredibly stressful experience.

Second, there's the legal framework of accredited versus unaccredited investors. Friends and family rounds often unknowingly get entangled in Securities and Exchange Commission (SEC) regulations. These rules are there to protect people from losing it all—which is a very real risk in a startup investment. If you see your company being acquired in the future or going for a VC round, obtaining money from friends and family could throw a wrench in your gears. It will come up in the audit phase of the process; there's no way around it.

Third and most important is the potential for irreparable damage to relationships. Friends and family are more than just potential investors. Mixing personal relationships with business is a road fraught with danger. If the thought of losing Aunt Jane's $20,000 investment and having to face her at Thanksgiving makes you sick to your stomach, it might make sense to skip this option and look for capital elsewhere.

BANK LOANS

Getting a small business bank loan is a challenging endeavor made especially difficult since the 2008 financial crisis and the ensuing credit crunch. Today, it is virtually impossible to get a new business loan. To understand why, consider how banks handle risk.

Banks make loans—not investments—and they need their money back paid back with interest. Lenders will want to see a financial track record that demonstrates your ability to repay the loan. Without that business history, lenders can't determine if your venture will succeed and they'll have to default to the next best source of financial history: your personal credit based on your FICO score. As a result, most loans for new businesses require you to personally guarantee your loan. If the business fails, the bank will come for your personal resources. If you're not comfortable with betting your family's house, retirement funds, and resources against your business's success, you might want to look for alternatives to a bank loan.

And personal guarantees aren't the only downside. Most loans have financial or use-of-funds restrictions called covenants. These are specific clauses that must be met for you to stay in good standing with your loan. Unfortunately, the language of covenants—and their implications—is often murky.

We recently met with a startup founder in the Seattle area who agreed to a 50 percent growth covenant at his last startup, meaning the bank required him to grow 50 percent year over year to stay in good standing with the loan. One year, he missed the growth covenant goal (growing

48 percent instead of 50 percent) and the bank called the loan. The founder had to scramble to repay hundreds of thousands of dollars.

There are also cash-on-hand covenants, where a founder is required to keep a large portion of the loan balance on hand at all times—say $500 thousand of a $1 million loan—yet the company has to pay interest on the total principal, which is incredibly frustrating for entrepreneurs trying to allocate resources and grow their businesses.

Banks tempt entrepreneurs with interest rates low enough to distract from the dangers of a personal guarantee or a list of restrictive financial covenants. Don't ignore that fine print. For most early-stage tech entrepreneurs, bank loans aren't the safe option they seem to be.

CROWDFUNDING

Crowdfunding has taken off in recent years, mostly due to its accessibility. Most startups can get a campaign up and running on a crowdfunding platform in a few days, and everybody has social networks they can leverage for capital.

This ease of access is also one of crowdfunding's downsides. Easy entry means there's a lot of competition and noise out there—it's a very crowded space. The startups that succeed with crowdfunding are the ones that spend countless hours fine-tuning their messaging, marketing their product, filming a compelling video, and enlisting the help of early supporters. Yet the crowdfunding campaign itself can become very much like another job.

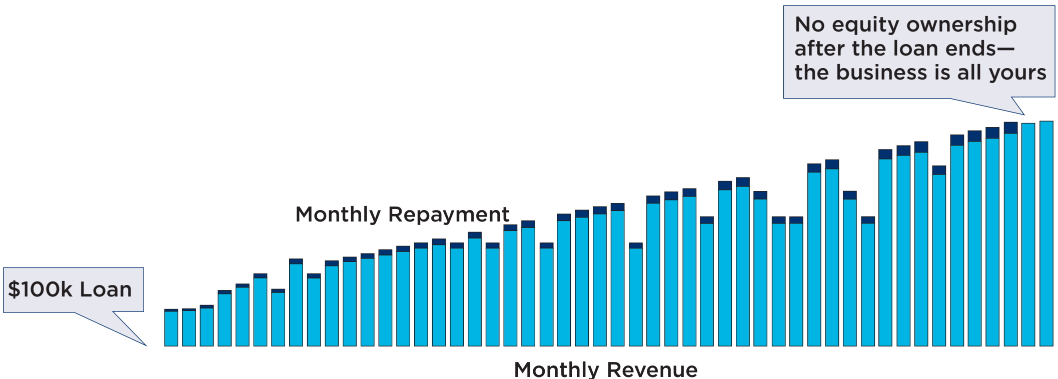
Think about this in terms of opportunity cost. The effort to promote a crowdfunding campaign is often equal to the effort of promoting your product to your first customers. One clear winning use case is if you have a physical product and you take preorders to fund the design and manufacturing costs of producing thousands of units at scale. In these scenarios, Kickstarter campaigns are often extraordinary proving grounds for you to get dozens—or sometimes thousands—of preorders and prepayments from future customers. This is especially useful for companies that target consumers (B2C) rather than serving other businesses (B2B).

REVENUE-BASED FINANCING

Revenue-based financing offers a hybrid option, taking the best features of debt and equity. With revenue-based financing, there is almost always no personal guarantee required and no equity surrendered. It works, and it's quickly gaining traction in the startup industry.

This type of funding is over 100 years old. It's used in Hollywood: when films are financed, investors give money in return for a cut of ticket sales. It's also used by the oil, gas, and solar industries. It's a proven method of financing, with no distractions and near total autonomy for the project owner. The best part? It is often much faster to get this funding—weeks as opposed to months.

FIGURE 1 Revenue-Based Financing 4-Year Loan Example



Here's how it works. You take a loan—let's say $100,000—and agree to repay it over a set time frame, generally three to five years. During that time, you pay back a percentage of your monthly revenues each month—generally between two to eight percent. The amount you repay is capped at a specific amount (referred to as the repayment cap). If your repayment cap is 1.6x, in the end you repay $160,000 total ($60,000 in interest and $100,000 in principal) over the course of the loan. Simple as that.

This model works well for two kinds of founders. The first are founders who never want to raise VC. These entrepreneurs are okay with running successful businesses that afford them financial security. They probably will never hit $1 billion in revenue, and they're totally okay with that. Selling their business for $5 million and owning 100 percent works really well for them. Revenue-based financing allows them to get the resources they need to expand and grow without giving up any ownership in the company.

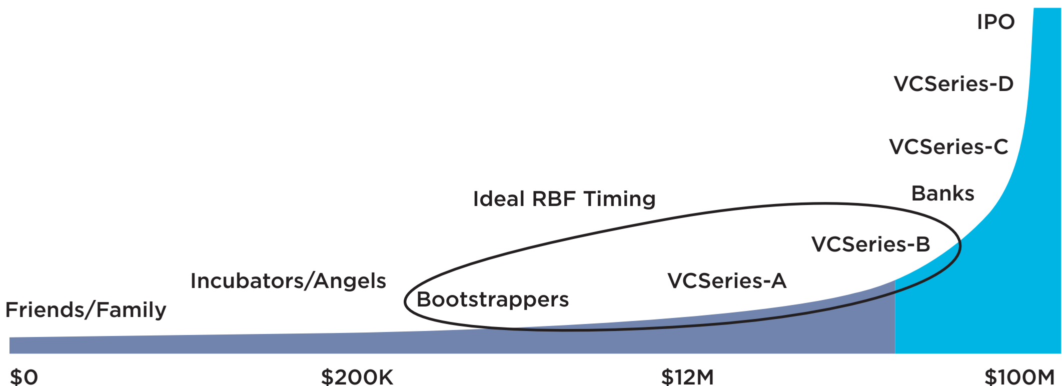
The second bucket of startups is those who want to delay VC fundraising. Maybe they need just a little more cash to close out their next big customer. Maybe they need capital to hire that sales or marketing leader. Or maybe they want to wait until they hit revenue goals or market traction before they speak with VCs so that they can negotiate a better deal. Revenue-based financing helps them improve their metrics without giving up ownership in the interim and eventually allows them raise a VC round at much better terms down the road.

In either case, revenue-based financing provides extraordinary optionality. Bootstrappers can later change their mind and go raise VC at much better terms. Or, founders who are on a VC track might decide to get off that train and preserve the remaining equity for themselves.

FIGURE 2 Revenue-Based Financing Breakdown

Example Terms	**Example Amount:**	**$100,000**	*You borrow $100,000*
	Royalty Rate:	**5%**	*You pay back 5% of monthly revenue, flexing up or down with net cash receipts (no fixed payments)*
	Repayment Cap:	**1.6x**	*Interest is capped at a specific amount, which is the max upside as RBF doesn't take equity or warrants*
	Total Repayment:	**$160,000**	*Simple total amount repaid over four years*

FIGURE 3 Sample Company Growth Journey



REMEMBER, YOU'RE IN CHARGE

There is a multitude of funding options available to today's founders. Which one is right for you depends on just that—you.

It may be that VC is the right path for your startup. It also might be that you just need a runway of fast cash to take your company to the next level. It's all a matter of where you see your startup going and what you need to get there.

Talk to us

At Lighter Capital, we love to talk to entrepreneurs about how you can fund your company's growth. If your company is generating revenue or soon will be, feel free to reach out. Visit us at www.lightercapital.com

About Lighter Capital

Lighter Capital is a fintech company revolutionizing the business of startup finance. We provide tech entrepreneurs up to $2M in capital to grow their startups while retaining equity and control. Our application and underwriting processes are powered by proprietary technology that lets entrepreneurs spend less time fundraising and more time building their businesses. Based in Seattle, we invest in companies across the US.

Need funding?