Give and take

Key structural considerations for companies seeking early-stage funding

INTERVIEWED BY MARK SCOTT

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It's difficult to focus on the long-term consequences of different financing options when your startup business needs cash just to stay afloat in the near term, says Mark A. Thompson, an associate at Kegler Brown.

Traditional bank financing can be hard to come by, "and that reality is amplified for startups and growth-stage companies with novel ideas and no revenue or operating history that they can lean on to obtain financing for future growth," he says.

When you need funding, the size of the check often seems more important than the legal structure. But different financing mechanisms give investors different rights and having an adviser who can help you navigate the legal framework for early-stage fundraising is essential.

"The dollar figure of the investment is important, but so is the structure. Entrepreneurs should always ask: What am I really giving up in exchange for the money?" Thompson says.

Smart Business spoke with Thompson about the need to think critically about the structure of early-stage financings.

How does the legal structure of an outside investment affect the cost-benefit analysis?

In equity financing, investors contribute money in exchange for an ownership stake in the company — they share in profits and losses and have some input on company decisions. Equity financing is cheap for the company and the founders in the downside case, because if things go poorly, the investors simply lose their investment. But equity can be expensive on the upside because the founders have given away a share of future earnings and control in order to obtain the financing.

Equity financing also requires the parties to set a valuation for the company to determine the share price for investors. This can be difficult at such an early stage, and be costly down the road. Undervaluation can result in substantial dilution of the founders in later financing rounds; overvaluation can discourage future investment.

In debt financings, the company borrows money from debtholders and promises to repay the money over time with interest. Debtholders do not have an ownership interest in the company, so they generally exercise less control over company decisions and the company's repayment obligations do not vary with its profits and losses.

Debt financing can be expensive for the company in the downside case (it's typically secured by collateral and must be repaid even when the company loses money), and cheap on the upside (the debtholders are not entitled to profits above and beyond the amount of the loan and interest).

Hybrid instruments like convertible debt combine attributes of debt and equity. Convertible debt is debt that can be converted into equity upon certain events, such as a later equity financing round. Convertible debt can be advantageous to investors (and costly to founders) because it combines the downside risk protection of debt with the upside potential of equity for investors. However, convertible debt financings avoid the premature valuation issues associated with equity financings, and the underlying documents are generally simpler to negotiate and draft. This helps founders cut down on excessive long-term dilution and upfront transaction costs.

These are basic examples, and you may not have a choice among investors or deal terms. But when you do, it's important to fully appreciate how deal structures can affect outcomes.

What are some key mistakes companies make at the early investment stage?

One of the biggest mistakes is overreliance on terminology as a substitute for understanding the business deal. The startup space is littered with buzzwords that make for helpful shorthand but can also mean different things to different people.

For example, you might agree in principle with an investor on a 'preferred stock' financing or convertible debt. But the actual substance of those deals depends on highly negotiated terms — the exact nature of the preferential rights accompanying preferred stock, the conversion formula for the convertible note. These terms have real impact, and discrepancies can prolong negotiations, make it more difficult to reduce the agreement to writing and ultimately increase legal fees. It's more efficient to spend time on the details in advance than to have your attorney draft financing documents by trial and error. ●