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## INVESTMENT INSTRUMENTS

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Quick Summary: There are several different types of investment instruments that should be considered.

**Abstract:**

*“Getting Capital” or “Raising Money” is probably the largest and certainly the most frustrating issue on an entrepreneur’s mind. Before the entrepreneur begins to focus on who they should contact for funding, they should first consider the many types of investment instruments available and which category best suits their needs.*

At best, this article needs to be thought of as a broad brush listing of the various sources of capital that an entrepreneur or company should consider. It is important to remember the Mark Twain quote, “Every generalization is false, including this one,” when considering the options listed below. The alternatives are listed in order to minimize the amount of equity that must be offered to secure funds.

The article in this series, *“Investor Categories: A Baker’s Dozen,”* provides a better description of the source of these funds and types of investment instruments each investor category prefers.

- **Personal Investment:** Also known as bootstrapping, this category involves the entrepreneur funding the company him or herself. The article in this series, *“Bootstrap Wisely”* provides details on this option. In addition to allowing the entrepreneur to maintain 100% ownership in the company, it demonstrates to others their total commitment to the business, which, in turn, will help them raise money in the future if needed. There are obvious financial risks to the entrepreneur. The entrepreneur must remember that the typical startup journey can take three or more years before the business generates enough cash to allow sustained operations.
- **Crowd Funding:** This model for raising money is new. It consists of posting your product or service idea or project on the Internet and soliciting donations from others. Donations can range from a few dollars to a few thousand dollars. In return, donors may be offered an initial product, a discount, a beta or trial offer, or just the satisfaction of knowing they helped the requestor. There is no equity associated with the donation and no guaranteed returns.
- **Unsecured Loans:** The most common source of these loans is from friends and families who have a personal vested interest in helping the entrepreneur succeed. Calling these loans unsecured is probably a misnomer. They may be unsecured from a physical asset perspective, but from an

emotional standpoint, they can carry an expensive, strained relationship burden if the business is not successful.

- **Grants:** Government agencies, private institutions, company grants, high net-worth individuals, or trust funds may be available to businesses focused on “civic” or “charitable” services. This type of investment does not require equity or the pledging of assets. These grants or loans may be thought of as donations for the “common good.” The business or service will most probably be required to operate as a non-profit organization. Some for-profit companies may also be able to take advantage of these common good donations.
- **Prepaid orders:** Of all of the funding sources available, this category is probably the best for the entrepreneur for several reasons. First, they provide external validation by the willingness of the customer to pay in advance for the offering. Second, there is no need to give up equity. Third, there is no interest on the money received. In fact, the funds received can be used to cover other expenses. Fourth, it provides a clear focus for the company with their need to fulfill the customer’s order and earn the trust that has been placed in them.
- **Secured Loans:** Loans from banks, Federal, state, or local agencies may be available but require the pledging of company or personal assets. They can be obtained provided there is sufficient collateral and the lending institution, through some level of due diligence, is reasonably confident that the loan will be re-paid. Most institutions will also require covenants that generally restrict the use of funds to specific activities or require the company to reach specified performance milestones. If the covenants are not met, the entire outstanding balance of the loan can be deemed payable when the breach occurs. Some loans, especially those that specialize in lending money to startup companies, may require the receipt of warrants (~ stock options).
- **Simple Agreement for Future Equity (SAFE) Instruments:** This category is new and quickly gaining widespread interest and support. A SAFE is very similar to a Convertible Note as described below with one major exception: it is not a loan that must be re-paid. Instead, it is an agreement that allows the investor to purchase stock sometime in the future when a Series A funding round occurs. The investors are allowed to purchase the stock at a pre-defined discount from the Series A investors to offset the risk that they have taken. SAFE documents are very short, perhaps two or three pages. Samples are available on the Internet. This simplicity significantly reduces the expenses associated with legal fees and deal-term negotiations. Since there is no obligation to pay them back if the company fails or never has an equity round, they are considered “entrepreneur friendly.”
- **Convertible Notes:** Sometimes referred to as convertible bonds are loans allow the lender to convert the amount borrowed to stock at some future time or cash at a specified interest rate. When converted to stock, convertible notes are an equity instrument. This technique has a significant advantage over the issuing of stock as described in the next category. With convertible notes, the company valuation, and therefore, the percent ownership associated with the investment is not determined until the an equity round occurs. With pre-revenue or early-stage revenue companies, establishing a reasonable valuation is always challenging. Convertible notes allow “collaring” of the

valuation that can be acceptable to both the company and the investor. The note with its accrued interest becomes payable when the note expires if an equity round does not occur.

- **Common or Preferred Stock:** The issuing of stock is the most commonly discussed funding source for startups and is associated with angel or venture capital investors. Generally, because of the high-risk nature of early-stage companies, investors insist on the issuance of Preferred Stock instead of Common Stock. Among many other things, Preferred Stock owners receive their investment returns before any common stock shareholders receive theirs. Additionally, the investment vehicle usually contains many other preferential terms that can significantly increase their overall value as well as place limits on the company by requiring approval of company actions. The article in this series, "[The Valuation Trap](#)," discusses some factors that can impact the actual equity associated with these types of investments.

With the brief discussion of the eight categories listed above, it might seem that an entrepreneur has many options to choose from. In actuality, based on the stage of the company, the type of product or service, and the amount of investment required, the number of choices quickly diminishes. Before selecting which options to pursue, an entrepreneur should seek guidance from someone who has startup experience and can help make a realistic assessment. If you think you can pursue three of the listed options, you need some sound advice!

Do not be surprised if an investor suggests a significant variation from one of the abovementioned options. Just as entrepreneurs are creative, professional investors, in competition with other investors, and attempting to arrive at the most favorable terms for themselves, can be equally creative. A few of the potential variations include:

- Making loans in exchange for a certain percentage of the current and future recurring revenue, perhaps forever.
- Providing funds in exchange for a royalty based on shipments that can last forever or until the investment is paid off.
- Receiving a percentage of revenue until some multiple of the investment is paid back with equity reducing over time consistent with the re-payment.
- Additional equity in terms of warrants based on missing revenue or other company milestones.

Whatever the terms of even the most seemingly simple and straightforward financing arrangement, engage an attorney who is well-experienced in startup investing before you sign any documents. Also, analyze the deal assuming that revenue is delayed, revenue is far exceeded, or an exit occurs at some future point to determine the impacts of the investment and equity associated with the deal. You may be involved in these types of negotiations once or twice, while some investors may have been involved in dozens or even hundreds of deals. Who do you think has the advantage? Be careful.