CORPORATE LIFE CYCLE

Start-Up and Early Stage Funding

Early stage firms have to assume a low financial risk profile, amid their high business risk.

Initial or founding capital in early stage funding rounds typically serves the purpose of kick-starting research and the development of a prototype. Such funds are foremost raised by the company founders, who will also take the majority stake in the company. These funds will often be complemented or followed by minor and low value investments, mostly by friends and family. - In addition, seed investment may be obtained from business angels: Their respective contribution – which, next to funding, should ideally also include an active involvement, such as mentoring, coaching and providing network access – will usually be in exchange for equity, maybe also for convertible debt. – In this stage investment documentation is typically light, merely including – among others – a shareholders' agreement and a short form subscription agreement with limited or no warranties.

A venture capital fund (VC) typically invests in a company within reach of generating some revenues. A first-round VC investment is often also referred to as 'A round'. Companies at this stage will be unprofitable and venture capital financing will be used foremost to counter negative cash flows caused by operating costs, capital expenditures and working capital funding. VCs will usually make investments certainly larger than any existing investors to date and will therefore demand a material equity stake in return: VCs will expect transaction documentation providing specific investor protections, the company and founders will enter into a long form subscription and shareholders' agreement, backed by a package of warranties, with constitutional documents containing preferential rights for series A investors, such as liquidation preferences and anti-dilution provisions.

Subsequently, so-called series B, C, D investment rounds etc. may follow enabling the company to scale its business. At this stage also private equity funds or certain strategic investors may join the VCs with the size of investments increasing as the value of the company grows. – With the company nearing the exit stage for these investors, there will be an increased focus on liquidation preferences and pre-IPO reorganization mechanics.

The engagement of strategic investors participating in these funding rounds is also referred to as vendor funding. Such an involvement can be highly beneficial for a firm: It may accelerate significantly progress through shared know-how and market excess. On the other hand, the investee loses substantial flexibility in regards to a later exit, as the strategic investor will probably have a first right to acquire stakes of divesting shareholders or it may decide to remain in the firm. Therefore, at this stage strategic investors may diminish the attractiveness of an acquisition by other, competing strategic players. And this, in turn, may either reduce the value of a firm or even make an exit pretty cumbersome, as the strategic investor may be taking advantage of its bargaining power,

Institutional investors usually participate in pre-IPO funding rounds with a view of exiting the company within an agreed period of time, often within 3-5 years. This exit is then achieved by way of an initial public offering (IPO) or M&A transaction. During this crucial phase the company may look for bridging / pre-IPO funding to support its continued expansion, whilst underway of preparing the exit strategy for some of its investors. – The pre-IPO reorganization steps may require collapsing various share classes into a single one that will eventually be admitted to trading. Further, the firm will need to establish investor relations, ensure that appropriate board members have been appointed and start entering a dialogue with one or more investment banks to structure the exit strategy.

BUSINESS RISK	HIGH
FINANCIAL RISK	LOW
FUNDING INSTRUMENTS	EQUITY
FUNDING SOURCES	ENTREPRENEURS FRIENDS, FAMILY ANGEL INVESTORS INCUBATORS VCs (STRATEGIC INVESTORS)
DIVIDENDS	NO