Financing Rounds with Private Capital

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1 Introduction

A start-up is an emerging technology-based company whose main problem throughout its development may be a lack of financing. This is because, unlike more traditional business models, these types of companies operate in new and disruptive markets that carry a high risk for the banking sector.

These types of companies need to financially cover any technological development and the market launch until they are able to generate their own resources. However, the lack of indicators and traction in the earliest stages of the business means that these companies do not find bank support and are forced to seek other types of financing, both public and private, and the aim of this chapter is to analyse the characteristics of the latter.

In addition to an in-depth knowledge of all sources of private financing and at what point in a company's life one or the other is appropriate, the preparation for companies to cope with this type of financing will also be discussed in detail.

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2 At What Point Should a Company Consider Seeking Private Finance?

The amount of capital a start-up needs and the timing of raising it will depend on the initial equity capital that the co-founders have, as well as the nature of the business. Equity capital is the money that the co-founders contribute at the time of incorporation of the company to start the business. But it is not only at the start of the business when a start-up may need external financing, but also during the course of the company's life and its different stages. All of this must be linked to the strategy and milestones that each company has set.

Today, there are a multitude of companies with different business models, some more capital-intensive than others. These companies, in turn, have management teams with different management styles. The growth perspective of a business changes depending on whether we are talking about a traditional business model, for example, a manufacturer and retailer of shoes, or whether the analysis refers to a digital native brand, companies that are created in the online world and their marketing is carried out through their own electronic channels. These businesses have a strong brand identity and a defined community.

Not all businesses have the same needs or interests. This difference is greater when you have a traditional business that sells and invoices shortly after setting up their business and growth is expected as its turnover increases. Therefore, growth occurs organically according to the resources generated by the company itself. However, for business models where the scalability component is fundamental, i.e., where the same resources are used to achieve greater income, entrepreneurs or business people resort to obtaining external, public, private or combined resources to boost growth and design strategies for financial leverage.

In summary, each company will have to analyse the ideal and appropriate moment to seek external financing based on its objectives, and this will require careful planning and preparation.

3 Phases of an Investment Round

When companies launch themselves into the market in search of financing, they must have previously defined a target volume of funds. This volume falls under the term financing or investment round and comes from an Anglo-Saxon nomenclature that arises from the need for entrepreneurs to obtain capital to finance their companies.

This fundraising can be carried out in different settings, individually, where only the entrepreneur and the investor participate, or in one of the most common spaces, the investment forums. These forums consist of rounds in which entrepreneurs show investors the strengths and innovations of their companies. This is a process in which the company gets one or several investors to invest a certain amount of money at a certain time in exchange for a percentage of the company's share capital or a loan, thus acquiring the status of shareholder or stakeholder.

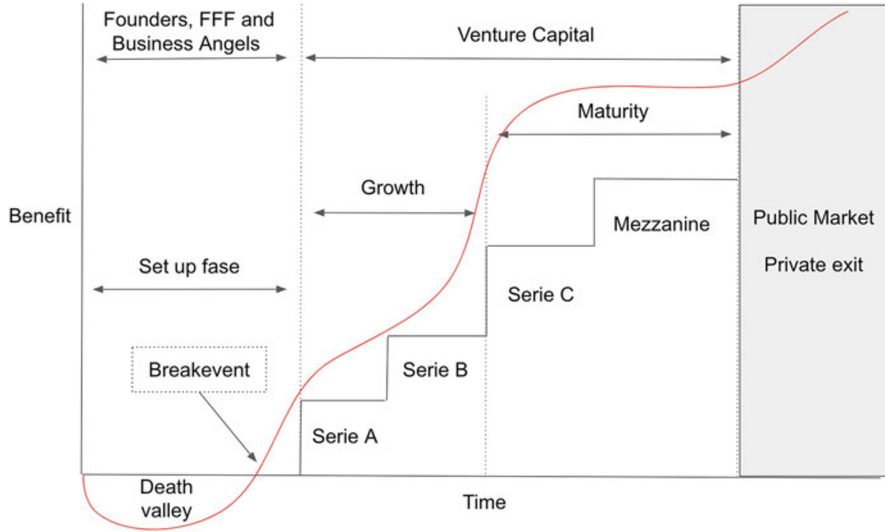

Fig. 1 Development of investment rounds

Closing a successful financing round can take between 3 and 6 months, depending on the experience and contacts of the CEO or other co-founders, as well as the development of the company. For this reason, it is essential to start working on planning in good time, especially if the company does not have sufficient resources or liquid assets in the medium term.

Start-ups have a predefined life cycle that begins in the development phase of the idea (ideation) and where, generally, there is no availability of funds, and ends with the sale of the company, both public and private, or exponential international growth. Obviously, this is without taking into account the fact that 80% of start-ups fail to develop the business model and, therefore, end up being closed by the shareholders.

However, depending on the business model and the stage of the life cycle in which the start-up finds itself, its financial needs will be different. Each phase involves a stage of business development and is associated with financial requirements that are backed by specialized investors in each of these stages. This is shown in Fig. 1.

Each of the phases is described below:

Initial Phase: Pre-Seed Development of the idea with the entrepreneurs' own money or that of friends and family. This is a stage of market research and analysis, competitor analysis, product-market fit and development of the MVP (minimum viable product). The MVP consists of a first version of the product or service without its full functionalities, but which allows validation with the clients of whether the product or service solves the problem that the entrepreneurs had detected in the

analysis phase, as well as gathering the necessary information from the clients to finish designing the product or service according to the needs of the market. This phase ends with the validation of the business model and the creation of the necessary team to carry it out.

Early Stage: Seed/Early Stage It is now possible to measure the business and its main variables with more precise numbers. And in many cases, the company begins to make itself known, through the media and its own customers.

Growth Phase: Growth This is one of the most critical phases of a start-up's life cycle. As a general rule, the company is at the break-even point with an appropriate cost structure and is competitive in the market.

Expansion Phase: Growth The benchmark for this phase can be geographical expansion or new products/services offered. Only companies that have achieved a good product-market fit are those that manage to reach this stage.

Sale: Exit It is quite possible that many of the companies that reach the expansion phase will remain in it, enjoying a well-functioning and profitable business. However, there will be many other companies whose objective is to sell the business, either to a potential competitor, to other large companies in the sector or to large private equity funds.

To advance in each of these phases, the company will reach certain milestones, which will help to increase the company's valuation in each round. However, the start-up sector is a sector in which the buying and selling of shares is not regulated. Therefore, supply and demand ultimately determine the price of a company. If the financial planning of the round has been well executed, the share price negotiation may be tilted in favour of the company. Conversely, if the planning has been poorly carried out, it is possible that the market will work against the company, and they will have to reduce the share price in order to raise the same amount of funds.

3.1 Planning and Preparation

The search for all types of financing requires good preparation and planning, and some reference manuals such as Gladstone and Gladstone (2002) can give a more professional view in order to invest as little time as possible in the search and closing of a financing round, as well as to obtain it in the most favourable conditions for the company.

Despite the fact that financial resources and the number of investments continue to grow, there is still more supply of projects to invest in than resources to invest in them. This is why companies need to be very well prepared before starting the search for investment and thus attract the interest of investors before their competitors do.

To this end, there is a good deal of research that needs to be carried out in advance. Some of this is outlined below:

Market and Competition Research By knowing the size of the market in which you operate, you will know what potential market share you can acquire and what resources you need to achieve it, as well as what the current weaknesses of your business are and how you can capitalise on them to distinguish yourself from others.

Financial Model Fundamental document for the planning of the financing strategy. This model is made in a spreadsheet and must contain an exhaustive, historical and future financial analysis of the main variables of the business, as well as the balance sheet, the income statement and the cash flow, the control of the latter being the most important factor. The aim is to know the exact financing needs for the short, medium and long term, depending on the objectives and milestones to be achieved. With this study, the possible future investment rounds are planned for a period of 3–5 years, depending on how far ahead the forecasts are being made. Therefore, this document sets out the company's investment strategy, which will undoubtedly be linked to the company's financial strategy.

Based on the data available, it is difficult to predict the future in a fast-growing business, although it is true that similar and comparable business models can be sought, albeit in other sectors or other markets. The design of the financial model requires the use of a large number of comparative resources to try to achieve realistic approximations.

Caution is one of the fundamental considerations here; therefore, the financial model must be based on the financial reality of the company in order to translate the set strategy into numbers in the future. Thus, there must be consistency with the information transmitted to the investor in the different meetings held, in relation to the current reality of the company and what the future numbers reflect in the spreadsheet. Ambitious financial planning will often generate uncertainty for the investor. Therefore, working with different scenarios depending on the growth of the company is the best option to generate a climate of trust with future shareholders. It may seem obvious, but a financial model does not remain stagnant over time, but needs to be updated according to the company's current situation and the sector in which it operates.

Once the growth variables have been set, the volume of funding required can be defined. On a prudent basis, taking into account an entrepreneur's optimism about the reality of his/her own business, it is advisable to increase the projected financing needs by 20%. The amount of financing needed should at least cover the company's objectives for the next 12–18 months. However, the amount of funding required must be in line with the valuation that will be set for the company, in order not to overly dilute the founding partners' stake at the beginning and in the following phases.

Other Investment Documents

In addition to the financial model derived from the economic-financial analysis of the company, the following documentation are required in order to start the investment search:

1. One Pager or Executive Summary Short version of the company's presentation, which should be no longer than one sheet of paper on both sides.

2. Investor's Deck Support document of the entrepreneur in relation to the investor, the main objective of which is to capture the investor's attention.

3. Business Plan Extended version of the company description, business model and strategy.

4. Cap Table A document that breaks down the company's share capital among the different shareholders and their respective percentages. It is important that the fully diluted version is shown, as this will take into account not only the shares that have been put into circulation through the various capital increases, but also those that will be issued if stock option plans are implemented with employees or if convertible loans are capitalised.

5. Partners Agreement Private document reflecting the agreements adopted for the proper functioning of the relationship between the partners and the company.

6. Other Legal Documentation The company must have available the deeds of incorporation and other capital increases, the convertible notes or the letter of intent (term sheet or LOI) depending on the format of the investment round. The latter two are the documents where the investor shows its interest in investing in the project and the terms of its entry are set out. Once signed, the investment is finalised through the transfer of funds. However, it is important to stress that neither of these are binding.

In more advanced rounds it will be necessary to have a confidentiality agreement (NDA) to ensure that information shared with investors cannot be disclosed to third parties, especially prior to conducting due diligence.

The preparation of all these documents is essential, but it does not mean that the company should not be in possession of any other relevant information that may be requested by an investor in case it needs to carry out a due diligence prior to making its investment.

3.2 Research

Having discussed the investment phases in the life cycle of a start-up, as well as analysing the supporting documentation to support the business in the search for funding, this section explains how to approach the process of finding investors.

The search for investment begins with drawing up a list of potential investors to contact, according to the sectors and stages in which they invest. These lists can be taken from public sources or investment platforms. It is advisable to start with as extensive a list as possible and add to it as the investment round progresses.

After drawing up the list, each of these investors must be screened, both to find out whether they are in the investment phase and also to find out their criteria

(rounds, average ticket, sectors with synergies, etc.). Knowing which companies the investor has in its portfolio is essential for designing the strategy with each investor, as well as knowing the companies in its portfolio in case it is already a partner of the competition and to be able to obtain references, so as to avoid having partners who may become conflictive or generate friction in future sales.

3.3 Commercial Process

The search for financing is a process in which the company tries to show its best image in order to attract investors. Therefore, once the company has drawn up a list of potential investors, the first contacts are made.

There are different ways to establish contact with potential investors, such as investment forums, business angel networks or directly through LinkedIn. But possibly one of the most effective is referral, thanks to the fact that other investors or acquaintances in the professional environment can put the entrepreneur in contact with the investors of interest.

It is very important that the company documents the results of each meeting. There are many investors to be dealt with and a lot of information to be gathered.

For a better monitoring of the process it is very useful to use an IRM (investors relationship management) and measure it as a conversion funnel, similar to the one used for customer acquisition.

In this funnel, investors can be placed according to the degree of progress in the process and the degree of interest where they can be classified if there has been interest in the first contact, through the sending of more information to continue analysing the investment opportunity until the final moment of receiving the funds and signing the investment agreement. In this way, you can quickly find out how close or far you are from concluding the financing round.

3.4 Negotiation and Closing

It is possible that the investment round may be delayed and this may jeopardise the liquidity of the company. Therefore, any leverage around the project that may favour the closing of the round should be taken into account. Some examples could be a lead investor, i.e., a benchmark investor who is one of the first to invest a significant amount in the project, which could generate a FOMO (fear of missing out) effect. Showing several months of positive development in the business is another variable that motivates investors. It is also valued to take advantage of the good news of the sector to create expectation.

It is necessary to be prepared for all possible questions that the investor may have or to know how to defend to the hilt all the points of the shareholders’ agreement, valuation of the company or other critical points in order to show confidence and conviction. If there is any point of tension with the investor due to neither of the parties giving in on some points, it is also positive to draw some red lines, up to

which the entrepreneur could give in to the investor if he/she is very interested in the investor's entry into the company.

In the book *How to close funding rounds successfully* by Feld and Mendelson (2017), special mention is made of the most common negotiation techniques in venture capital.

3.5 Due Diligence and Auditing

The due diligence (DD) process consists of an exhaustive analysis of the main employment, commercial and legal aspects of the company to ensure that there are no potential risks that could influence the business a posteriori and that it would be impossible to be warned of with the previously mentioned documentation. Therefore, in this process, special emphasis is placed on all contractual obligations of the company.

At certain stages of the start-up and depending on the type of investor, normally from VC funds (venture capital) onwards (depending on the amount invested), it is common to ask the entrepreneur to undergo a due diligence process or request an external audit of the start-up by a firm of recognised prestige. Both of these will provide veracity of the start-up's operations and financial accounts, as well as facilitating knowledge of other possible contracts that may entail a significant payment obligation.

Unlike a DD, an audit process is based on the opinion of an external and independent professional on the company's financial statements in accordance with generally accepted accounting principles. Some companies are obliged to go through an audit process. However, in companies that do not yet meet these requirements but are involved in large investment rounds, it gives investors a certain degree of security that the process has been carried out on a voluntary basis, provided that an unqualified report is obtained, i.e. that no non-compliances are detected.

3.6 Post Closing

Depending on the country in which the capital increase takes place, there are a number of legal obligations, such as the capital increase must be approved by the general meeting of shareholders, notarised and registered in the commercial registry. There is an obligation to inform the shareholders arising from the shareholders' agreement. A regular information channel with the shareholders will benefit the relationship with the shareholders and even in the follow-on in future rounds.

3.6.1 Post-confirmation of Investment Compliance Procedure

After the closing of transactions, where the company has new shareholders, it is necessary to follow a strict protocol for the storage of documentation. Such information is highly sensitive for all purposes. Therefore, it must be meticulously recorded.

It should be kept under lock and key and only accessible to the team responsible for updating and maintaining it.

When designing and setting up the documentation system and the information to be included in the registers, it should be borne in mind that this varies according to the stage and legal form of the company receiving the investment. In this respect, companies where the shareholding structure is much more complex or where there is an obligation to be audited, will be subject to much stricter requirements than newly created companies.

Once the investor's commitment has been obtained, appropriate traceability of the origin of the funds must be generated, as well as knowledge of the ultimate beneficiaries behind the entities making the investments.

In this respect, by virtue of the Law on the Prevention of Money Laundering and Terrorist Financing, it is customary for investors to complete a KYC (Know your customer), a basic document specifying the investor's key data (address, name, main activity, etc.) which will later be used to draw up the legal information and obtain proof of the origin of the funds.

The KYC contains the following information:

- Customer statements and risk factors, relating to the sector of business and commercial activity or countries in which they operate, as well as whether they have held past or present public office or are involved in criminal activities.
- General information concerning the customer depending on whether the customer is a natural or legal person: name and surname or company name, legal status, date of birth or incorporation, nationality, tax domicile for communication purposes and identification document (type, number, country of issue, expiry date).
- Origin of funds and banking entities. Last beneficial owners (only for institutions), specifying the investors with more than 25% of the shares of the investing company.
- The tax owner (for entities only). This case is specific to those investors who have several holding structures. Where the natural person who has effective control may be behind several interlinked companies.

The registration of the investor's documents is essential to provide a record of the company's analysis. In this way, the finance or compliance department can ensure that the benchmark investor did and does meet all the criteria for acceptance of the transaction. The documents that should be included in the investor's register are as follows:

For a natural person:

- Passport or national identity card.
- Tax identification card.
- Document accrediting the legal origin of the funds. For this purpose, it is usual to have the latest tax return filed.

- Bank certificate issued by the bank showing the account number from which the payment is made.

For a legal person:

- Memorandum of association.
- Articles of association, shareholders' agreement and bylaws.
- List of the directors of the company.
- Passport or national identity card of the representatives or signatories.
- Deed accrediting the power of attorney by which the signatory acts.
- Tax identification card.
- Activity of the investor, providing: (a) latest annual accounts or (b) latest annual taxes filed.
- Bank certificate issued by the bank showing the account number from which the payment is made.

All documentation must be updated at the time of modification or expiry of the documents in order to keep the file complete and up to date.

Once all this information has been collected, we must include the documents evidencing the closing of the transaction, adherence to the shareholders' agreement, convertible notes and any other additional document generated and signed by the investor in the process.

3.6.2 Documentation to Be Received by the Investor upon Completion of the Transaction

After the collection of the investor's information, the assessment of suitability and the registration of the capital increase transaction with the notary, the investor becomes a stakeholder or shareholder in the company and obtains political power within it.

Therefore, once the transaction has been registered, it is essential to send investors a summary of the content of the transaction which sets out the final outcome of it. The documentation to which investors will have access will be as follows:

- Copy of the public document specifying the holdings or shares that have been given to each investor and the economic counterpart of the transaction. In this way, existing and new shareholders know the status of the company's assets.
- Cap table. Once the investment has been made, the old shareholders will reduce their percentage to accommodate the new shareholders, which is known as dilution, so the percentage distribution of the invested company will change. Both new and old shareholders will receive this table with the shareholding situation of the company after the capital increase.

4 Types of Funding Round

Having analysed all the qualitative and quantitative aspects, this section focuses on the typology of financing rounds. In the world of start-ups, it is identified by a set of acronyms and concepts derived from Anglo-Saxon terminology.

These small private financing windows for unlisted companies can range from contributions from non-professional investors of no more than 50 euros to investments of several 100 million euros led by large investment funds.

In order to try to narrow down the ranges of such operations, there is a nomenclature based on three main aspects:

- Amount invested.
- Valuation of the company.
- Purpose of the investment.

In any case, this is an inefficient measurement system that fluctuates depending on the regions or markets where the company operates. Based on the calculations in the annual report issued by Pitchbook (2020) in certain phases the amount of investment and valuation in the same stage, for example, pre-seed, can be up to 4 times higher in the American market versus the European market.

This means that if a pre-seed start-up in Europe gets a million euros, a start-up in the same stage but in the United States would get a larger injection of capital to tackle the same ‘stage’.

There are standards for defining each of the phases, which are outlined below and summarised in Fig. 1 and Table 1.

Table 1 Phases and characteristics of the investment stages

Investment phase	Investment	Characteristics
Pre-seed	5–500 thousand euros	– Validation of the business model – Configuration of the promoter team – Problem-solution – Stage with the greatest risk/return potential
Seed	500 thousand euros to 2 million euros	– Recurring sales – Validation phase – Organic month-on-month increase in sales – First signs of the power of scalability
Series A	2–10 million euros	– Scalability – Expansion – Phase where profit generation begins
Series B	10–20 million euros	– Leadership in a given market – Preparation for aggressive expansion and positioning as a benchmark in the sector – Growth with maximum liquidity – Pre-IPO phase

Pre-seed The initial phase of the project where a quick validation of the minimum viable product is sought in order to know the potential that the solution proposed to the market may have. Phase where the first customers who are willing to pay for an unfinished product enter.

Seed The seed stage is one of the most dangerous stages in business development. It is common for many planning mistakes to be made at this stage, leading to excessive dilution mainly due to financial planning that is misaligned with real cash flow needs and the development of the business. In the seed stage, the company is perfecting the product and starts to see recurring revenues, which confirms that there is a need in the market.

Series A The start of the series (A, B, C) marks the beginning of the scalability and consolidation of the business model. In the company's first series, the main focus is on scaling the business to maximise profits and broaden the range of markets in which it operates.

Series B After business consolidation (stabilisation of revenues, stable margins) it is common for companies to seek a series B and C to consolidate the revaluation of the company and adjust its value prior to an IPO (Initial public offering) or aggressive expansion and growth in pursuit of market or sector leadership.

The dilution of existing investors in each of the financing rounds is between 10 and 20% depending on the stage and business plan. Excessive dilution in each of these rounds could lead to an excessive loss of control by the founding team.

5 Types of Private Financing

For each of the financing phases described above, there are alternatives to turn to in the search for private financing. However, each of them has different characteristics when it comes to investing in start-ups, whether due to the stage the start-up is in, the amount of money to be contributed or the strategy when it comes to entering or exiting the investee's capital. The following list shows the types of financing according to investment capacity, from the lowest to the highest capacity:

- *Incubators and accelerators*: Are the most suitable to use in the pre-seed phase. When the company is still in the MVP or launch development phase, starting to validate its business model and obtaining its first metrics.
- *Business Angels (BA)*: A business angel, also known as smart money, is a private individual investor who invests his or her own capital, but has knowledge and experience in start-up investment. In addition, they usually have an important network of contacts, either through their own professional experience or by belonging to business angel networks. This is why they are usually beneficial for the development of the company. The investment that a business angel can

provide depends a lot on the person, ranging from pre-seed to growth rounds. They can be found on the main start-up investment platforms, investment forums of BA networks or business schools, as well as being mentioned in the news as participants in the main investment rounds of the ecosystem. Fund finders usually have access to most of them. However, the fees are often prohibitive in the early stages of a start-up's life.

- *Equity crowdfunding*: is the financing of a project by multiple investors through collective investment platforms, i.e. a project can be jointly financed by many investors without the need for them to invest a large amount of money. This allows less qualified investors to experiment with other investments and, in turn, these investors will take part of the company's share capital. The projects to be invested in are previously filtered by the platforms and support the whole investment process.
- *VC*: Venture Capital. VC funds, for the most part, start investing in the growth phase. When the start-up needs a large injection of capital to scale the business. They may cover the round in its entirety or invest with other specialised investors. They do not get involved in the business in the same way as a business angel, but they usually demand a seat on the board of directors to exercise a supervisory role. In addition, as VC managers have to thoroughly justify all investments to their investors, they put the start-up through a due diligence process.
- *Venture Debt Funds or Convertible Equity Loans*: This is another financing tool with the difference that most of the loan is repaid at maturity (between 3 and 5 years depending on the development of the business) and a small part is converted into shares in the company. They carry with them above-market interest rates resulting from higher risk-taking. They participate in rounds in which there is already a business angel or a benchmark VC with the aim of not assuming the main risk of the investment and taking a minority stake. Even so, they usually seek a seat on the board of directors to support the development of the business.
- *Family Office*: are high net worth families seeking to diversify their investments by investing in start-ups. Traditionally, the main business of family offices has always been the holding and exploitation of real estate assets, mainly because of the high profitability and tax benefits. However, following the tax reforms after the 2008 crisis, many family offices have found great potential for growth in the start-up sector, which in turn allows them to obtain large tax capital gains.
- *Public funds linked to private funds*: Public money invested by private venture capital managers, among other things, for the promotion and development of R&D, digitalisation and start-ups. It all leads to the use of mixed investment funds for further support.

6 Venture Capital Financing Formats

The final decision to be made is the format in which the capital inflow into the company will be structured. Within the start-up ecosystem, there is a wide range of solutions for financing start-ups. The main ones are detailed below:

6.1 Capital Increase

A capital increase refers to an increase in a company's shares or holdings as a result of the entry of new capital into the company.

This capital increase is not only intended to grant shares to new investors, but can also be a new distribution of shares among existing shareholders who have decided to increase their presence in the company.

One of the main disadvantages of designing a structured financing round entirely through a capital increase is that the availability of funds is released at the moment when the partners become, to all intents and purposes, shareholders in the company's share capital.

It is, therefore, common to carry out a combination of different types of financing so as not to compromise the company's liquidity if external factors affect the marketing of the new shares to be issued.

This type of operation is formalised by means of an investment commitment between the parties and a capital increase subscription contract to be accepted by all existing investors.

6.2 Convertible Note

Convertible notes are the second most common instrument used to raise funds for a start-up company. The concept of a convertible note is simply a loan between two entities, whether individuals or legal entities, which is entered into privately between the parties.

Another of the main uses of convertible notes is the possibility of setting a price range within which the final valuation of the company will be set. At certain stages of growth it may not be possible to fix an objective valuation based on metrics. This would, therefore, result in excessive dilution for shareholders.

This mechanism is structured on the basis of a cap and a floor, where the floor is the minimum valuation at which the loan will be converted in the event that the objective for which the convertible notes were designed is not achieved; it is usual to set the floor at the post money value of the last round so as not to harm existing partners. On the other hand, the cap is the maximum valuation at which the loan will convert. This happens when the company has achieved its targets and is raising more capital at a higher valuation. It is a mechanism that protects the investor who has taken a risk before the previous investors. The cap, unlike the floor, is a mechanism that protects current investors from over-dilution.

This type of loan has a series of specific conditions that greatly limit the lender's political rights, since it is a financial instrument that seeks to solve a company's short-term lack of liquidity, with the objective of ultimately executing a financing round.

It is, therefore, common to see convertible note contracts subject to a certain periodicity and the possibility of converting them into capital at the time the company deems appropriate, in accordance with the criteria set out in the contract. They usually contain a minimum interest rate that never materialises.

6.3 Venture Debt

Venture debt is another of the financing formats that is gaining momentum within the venture capital sector. It is essentially a financial product that is a hybrid between direct equity investment and a current loan. The operation is more similar to that of a loan, but with the peculiarity that the lender takes a minority stake in the form of equity in order to reduce the risk/reward of the operation. Unlike a standard loan, venture debt is divided into two transactions.

First, through an equity kicker, which is usually around 25% of the total loan, equity equivalent to that percentage of the loan is delivered to the lender. For example, for a venture debt of 1,000,000 euros and an equity kicker of 25%, 250,000 euros will be converted into equity at the valuation agreed between the investor and the company.

The second transaction is the signing of the loan. Despite having an equity kicker, this does not mean that the 250,000 euros referred to above no longer has to be repaid. On the contrary, the entire capital loaned by the venture debt must be repaid. This is one of the most common sticking points for entrepreneurs, as it can seem abusive. Not to be overlooked is the trend in the sector, where 80% of start-ups die before achieving profitability. This situation forces venture debt funds to cover this risk by taking shares. Otherwise, it would be impossible to undertake such transactions. It would become an operation more typical of a public entity that promotes entrepreneurship than of a fund, whose objective is to provide a return to its investors.

However, compared to other more traditional financial products, it is a more efficient method of financing for start-ups or companies seeking to increase their value quickly in the coming years where they will have to repay the loan money but will be paying it back with much higher income than they had at the point of origin. This financial product is not recommended for companies without high revaluation expectations as the interest and equity kicker can weigh heavily over the repayment period. Table 2 below shows an example of equity and venture debt financing of a company.

A start-up company is increasing its sales by an average of 20% month-on-month and is considering taking out a loan to accelerate sales and business development. Loan target 1,000,000 euros.

Table 2 Comparison of venture debt and equity

	Venture debt	Equity
Initial valuation of the company	5,000,000 euros	5,000,000 euros
Interest	7–12%	Na
Equity	25%	100%
Cost of the loan for 3 years	195,715 euros	0 euros
Valuation in 3 years' time	12,000,000 euros	12,000,000 euros
Cost of buying back the shares	500,000 euros	1,999,999 euros
Total cash outflow (interest + repurchase of units + repayment)	1,695,715 euros	1,999,999 euros

By the same criteria, it can be assumed that traditional (non-venture debt) loan financing may be a more efficient method of financing the company. However, the risk limits set by financial institutions prevent them from entering into operations of this type, mainly due to the inherent risk of the business.

On the other hand, venture debt tries to compensate for the excess risk with a portion of equity that will help it to achieve a return that is in balance with the risk assumed.

As has been shown above, the great danger of venture debt is not achieving a clear revaluation with the loan granted. In this case, both the equity provided and the loan repayment can strangle the business model financially.

6.4 Equity for Services

There are alternative forms of early-stage company financing that are not based on capital injections into the company. These forms of financing are based on paying for the cost of a given service with shares or equity in the company that is to receive the service.

This financing model is common when the objective of a financing round is highly focused on contracting or optimising a specific resource, such as technological development, marketing campaigns or other services.

The most common forms of equity for services are:

- *Tech for equity*: The aim is to subcontract technological development work that the company itself cannot take on.
- *Legal for equity*: On certain occasions, there are complex legal processes (sales of companies) that entail an unaffordable additional cost for the company.
- *Media for equity*: Campaigns in more traditional media tend to cost far more than the usual budgets of start-ups. Therefore, this type of financing is the bridge between the classic media of large companies and growing companies.

In the vast majority of cases, these financial instruments are executed through a private contract, the issuance of an invoice for the services and the capitalisation of this invoice in the company's share capital. Thanks to this operation and the intangibility of the business, it is possible to reduce the theoretical value of the services when the service provider understands the potential for revaluation of the work performed.

6.5 Crowdfunding

Crowdfunding was one of the most widely used financing instruments after the 2008 crisis because it gave access to anyone (professional and non-professional investors) to invest amounts from 50 euros. However, the professionalisation of the sector and the emergence of regulation have relegated this method of financing to the bottom of the list of most used financial products.

It is even common to think of crowdfunding as a financing instrument that is used once it has not been possible to close deals with other instruments.

Crowdfunding is one of the best instruments to finance engineering developments or physical products (not software). Physical products or products that will be sold directly to the end customer tend to attract much more attention from non-professional investors and can also be a useful financial instrument to achieve the first pre-sales.

An example would be the case of a crowdfunding aimed at financing the development of a new comb against hair loss and the development of software to make the user experience easier. An uncomplicated product with a good marketing positioning will get many more investors than a complex one.

The understanding of this method of financing is based on the syndication of a large number of retail investors to take a stake in a company. The main problem with this method of financing is the fragmentation of the investor base within the company.

This fragmentation generates a legal and supervisory burden that often slows down decision-making within the company. Spanish regulation, for example, sometimes requires the signature of all partners (regardless of their shareholding). Therefore, a fragmented cap table impedes agile decision-making.

6.6 IPO

IPOs (Initial public offerings) are forms of financing that companies undertake mainly to provide liquidity to investors who wish to buy or sell shares.

Once the maturity stage of the company has been reached, the investors who have accompanied the company in the growth phase have finished their journey within the company and are looking for liquidity windows to allow more conservative investors to enter.

Generally, investment banks are used as assistants in this type of operation, as it is these entities that have the contacts and investors for this first phase, known as book building.

As part of the service provided by banks, they are responsible for generating supply and demand in the first phase of the public offering, with the entity itself providing the necessary guarantees for the operation.

Although it is true that in more financially developed markets such as the American or the English market, it is common for start-ups to end up going public on a listed market to compete on equal terms with the rest of the operators. In this way, the 'startup' journey is usually over and the corporate journey begins, where the regulations themselves require the professionalisation of the different areas of the business.

7 Conclusions

As has been made clear throughout the chapter, there are a large number of variables that determine the feasibility or success of an efficient financing strategy.

This success lies primarily in planning, understanding and determining the needs of the company and the financing objective. Making the right decisions when it comes to financing the company will be of great benefit in the medium and long term. Therefore, it is necessary to know what tools the company has at its disposal to generate demand among investors and what the returns will be for them.

In turn, the strengths that are attractive to investors need to be identified, as well as which type of investors and which financial product is best suited to that type of investor.

At the end of the day, the positive conclusion of a financing round is measured when both the investor and the company are satisfied with the process, timing and mechanism for achieving the financing objective and profitability for both parties.

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