Smarter Funding: How to Get the Backing That Best Fits Your Startup

Going from $0-10 million in sales, most tech entrepreneurs think there's only one path to raise growth capital for their startups: selling equity in their business. It's a model that has been reinforced by several decades of tech companies feeding on a steady diet of equity money. This equity model creates a cycle for entrepreneurs: found, build, raise, grow, raise, grow, and then exit, hopefully at a top valuation (and without too much dilution or a down round, since that would wipe out your founder holdings).

Then after you exit, if you're really successful, you either spend lots of time on your sailboat, dabble as an angel investor and startup guru, or you repeat the process by starting another company and going at it all over again.

But things have changed over the past decade, and entrepreneurs should adjust their mental framework about startup financing accordingly. Here are some of the trends in the tech world that have impacted how startups raise money:

- Launching a product takes less capital than it used to. Especially if you have a SaaS offering, your cost of development, delivery, support, and updates cost so much less than the days of packaged software. Development is faster, and platforms like Salesforce and AWS don't require on premises severs and tons of tools, etc.

- Recurring revenue models take time to build, but over time the power of compounding is intense.

- Niche markets are easily served, meaning you can build great businesses and dominate a niche market without much competition.

- More financing options are available for tech companies than ever before – if you're creative.

If you're trying to raise money for your business, there are now many alternatives to VC funding, particularly for smaller tech companies. Let's look at some of the options:

Revenue or royalty-based financing

RBF is something of a blend between bank debt and venture capital. A relatively new type of financing structure, with RBF the company "sells" a set percent of its future revenues to the investor in exchange for a capital investment. The simplest way to think about it is as a revenue share between the company and the investor.

- Pros: This method of financing is more accessible than bank loans or venture capital, and the loan payments align with the success of the business as they are based on company revenue. Additionally, the company retains full ownership and control, and there are no personal guarantees or covenants required.

- Cons: RBF can cost more than other types of financing such as bank loans, SBA loans, or crowdfunding.

- Good for: Companies that have been in business for at least 6-12 months and have a recurring revenue stream and steady growth. Also good for companies looking for growth funding to scale sales, marketing or development efforts.

Customer pre-pays for long periods

There are many pros and cons to this approach, but overall it's cheaper than equity and it means your customers are committed to you.

- Pros: In addition to providing cash flow and working capital to cover operating expenses, pre-payments may drive higher customer retention rates.

- Cons: It can be hard to convince customers to prepay. This method also requires discipline to correctly manage cash flow. If you offer both monthly and annual payment options, you need to make sure pricing is appropriately discounted. Keep in mind that a prepayment discount is usually implied, i.e. 20% off if you pay for our tool/service annually vs. monthly.

- Good for: Companies with large customer bases and businesses with seasonality (think landscaping in seasonal climates).

Charge customers for non-recurring engineering (NRE) expenses

Charging customers for non-recurring engineering costs will pay for your dev team! But before you go that route, you need to make sure whatever you plan to develop is something many of your customers want. You don't want to allow one big customer's requirements to derail your value proposition and focus. And you need to make sure you get the customer and don't turn them off – you'll do this by being the best overall solution for them, addressing their needs best and forming strong relationships with them.

- Pros: Since you have to pay for development costs anyway, this route helps cover some of that cost. This capital boost allows you to build the features customers are requesting into your product.

- Cons: You have to make sure these requested features are functional and map to customer requests/expectations. Furthermore, if you don't estimate the project timeline correctly, it can end up costing you more time and money. Sometimes big customers can derail your product roadmap/vision.

- Good for: Companies with large, complex enterprise offerings and integrations, and highly integrated tech startups that need to build products connected to other platforms (AWS, Salesforce, Marketo, etc.).

Donation-based crowdfunding

No equity is involved here, so we're talking donation-based platforms like Kickstarter and Indiegogo. Crowdfunding only works for certain products, but some businesses have raised tons of money doing this. This financing method is simply booking customer sales in advance of having a product. It's the best type of capital you can receive from your customers and the best thing for your cap table, since there's zero dilution.

- Pros: Crowdfunding allows you to have customer sales locked in and front-loaded before you start production. It can also serve as a good way to test demand and provide good intel on target customers and market.

- Cons: You'll have the added pressure of a large number of pre-paid customers anxiously expecting their reward or product. Plus, your offering may be perceived as a beta product and signal you're not ready for prime time or in it for the long haul.

- Good for: Companies producing material goods or who are in early stages of testing their product and market.

Equity crowdfunding

To gain financing through equity crowdfunding, a large group of investors (aka the "crowd") gives you money in exchange for shares. If you go down this path, you may end up with dozens or even hundreds of investors, and there are more reporting requirements for investor protection, so it's important to know how it all works. Here's a good Equity Crowdfunding 101 article for reference.

- Pros: With an online offering page, you are able to quickly share the details of your deal. This method also gives you easy access to investors and their capital.

- Cons: There are many new and changing regulations around this model. While the JOBS Act is designed to open this type of investing to everyone, it has set limits. For example, if you raise more than $500K you'll be audited, and you can only raise $1M in any 12-month period (via non-accredited investors). There will also be cap table issues and concerns about what type of investors you are bringing on. Choosing to pursue this source of capital might mean losing the ability for your investors to also be advisors. Venture investors sometimes view crowdfunding negatively — they don't want to be one of dozens or hundreds.

- Good for: B2C and early stage startups with a Minimum Viable Product showing traction (# of customers/users, MAU, DAU). Companies that have real numbers and metrics that demonstrate growth.

Line of credit

Once your company has over ~$5M in sales, technology-focused banks such as Square 1 or Silicon Valley Bank can provide Accounts Receivable (AR) and Monthly Recurring Revenue (MRR) lines of credit. Types of covenants you may see for lines of credit are minimum net income thresholds, restrictions on additional debt, and minimal revenue growth. Then there are liquidity ratios, which mean you must have a certain amount of cash in the bank vs. how much is pulled on the line.

- Pros: In addition to low interest rates of 6-8 percent, you'll also have access to the capital even if you don't use it right away.

- Cons: You must give a personal guarantee. Banks will usually require a financial covenant to secure the loan, so that means your house, or other equitable property, etc.

- Good For: Companies with lots of accounts receivables and cyclical payment cycles, and companies with tangible assets.

As you review different financing options, it's important to make sure that the options you consider map to your business goals. Here are three key questions to think through:

1. Are you sure you want to sell your company in next ~5 years?

What if you really love what you're doing and want to run the business for a long time? If that's the case, equity probably isn't the best funding option, since the first letter in "ROI" is "R", and equity investors expect big returns – usually 10x or more. Successful businesses that never give a return to investors are a bad investment. It's not fair to equity investors and can create a lot of tension. It's hard to buy people out later, especially if you're successful, and it means you'll almost certainly be trading one equity investor for another equity investor.

2. Do you want to give up control?

Once you take on equity investors, it's no longer just you and your cofounder making decisions. You'll have a whole new audience you need to please all the time, in addition to communicating with your employees and customers. Some investors will want to provide input on strategic direction and decisions. And you'll likely get a new boss – a board of directors.

3. Are you really sure you want to "go big or go home"?

What if you just want to build and run a great business? Receiving VC money is like having a rocket strapped on your back – either you'll make it to the moon or you'll blow up trying. While your chance of making $100M goes up when you receive VC money, so does your chance of making little to no money.

Just to be clear: I'm not against VCs or taking VC money. In fact, I've been a VC myself. There are many amazing companies that use VC money to grow and succeed. However, I do think if you're looking at funding choices for your startup, you should go in armed with as much information as possible, because many times there may be a better option out there for your business.

BJ Lackland is CEO of Lighter Capital.

(appeared 4/10/16 in *VentureBeat*)