STARTUP SECURITIES

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LAWYERS

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SUMMARY

STARTUP SECURITIES is an easy to read primer that aims to acquaint entrepreneurs and small business owners with the world of startup funding. In its four sections you will find information about the tools entrepreneurs have at their disposal to raise capital and to motivate and reward investors or employees.

In the first section, **FINANCING AND INVESTING**, we explore the fundamentals of the relationship between new businesses and investors. We go over the three basic types of securities startups use to raise funds – Bonds (or generally loans and debt), Shares and Options.

We cover these specificities and explain briefly what value they bring to the holder and the issuer of the security. This is followed by a comparison of finance in private versus public markets.

In the second section, **STARTUP FUNDING**, we go over the drawbacks and benefits of financing your company with debt or equity.

We also cover a middle ground option presented by financial instruments called convertible notes.

The third section is dedicated to the topic of using **SECURITIES AS COMPENSATION**. We discuss the motivations behind this practice as well as its appropriateness in different situations.

In the final section, **ROADMAP,** we touch upon the practical issues of determining your funding needs, creating a fundraising strategy, choosing between passive and active investors and possibly motivating them with securities based compensation.

After reading this eBook, you will have a solid grasp of the basics of funding your company.

Most importantly, you will have an understanding of the types of financial tools used for startup funding and the shortfalls and benefits of using each one in different situations.

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FINANCING
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FINANCING & INVESTING

If you are reading this eBook, there is a good chance that you are running a small company or that you are considering forming one. In either case, you face the challenge of financing your activities until you have sufficient revenues.

One way of overcoming this challenge is to raise capital from investors and in order to do so your company needs to issue securities in return for the funding you receive.

Raising capital differs from most other economic transactions in that it involves a face to face negotiation between the investor and the company (you); a negotiation that you need to prepare for and understand in detail.

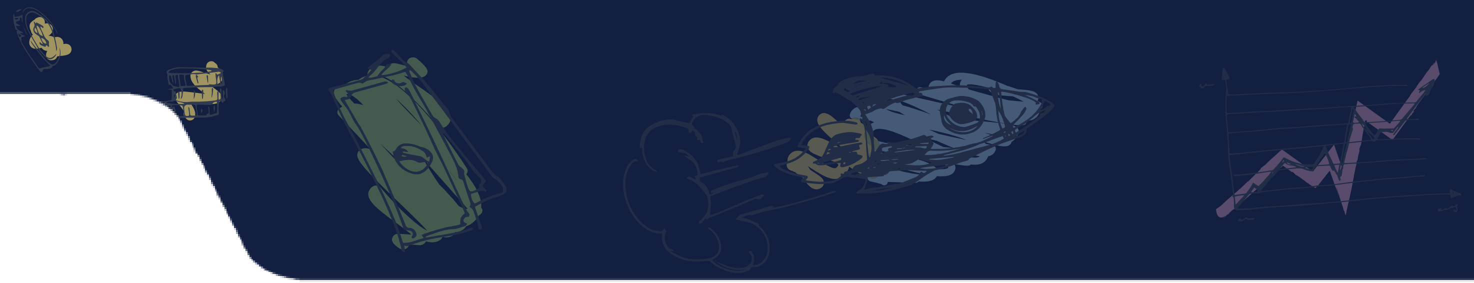
This means that you need to have a good grasp of the value you offer investors in return for their investments, and to this end, we will start with a quick rundown of the financial instruments you have at your disposal.

FINANCIAL INSTRUMENTS

The sophistication of financial markets has increased drastically over the last few decades, but since the purpose of this presentation is for you to become familiar with the most common startup securities, we only need to consider three basic financial instruments: bonds, shares, and options.

> **“... you need a good grasp of the value you offer investors in return for their investments.”**

With an understanding of these three financial instruments, you will be able to understand the vast majority of financial instruments traded in the marketplace, including the most common startup securities.



Bonds

A bond is a loan agreement between your company (the "**Issuer**") and an investor (the "**Bondholder**"). In its simplest form, it specifies how much money you must repay (this is called the "**Principal**") and when the payment is due (this is called the "**Maturity**" of the bond).

In most cases, the principal is also equal to the amount of money you receive in return for the bond, but this is not always the case so it is important to distinguish the two. We will therefore refer to the latter as the "Price" of the bond.

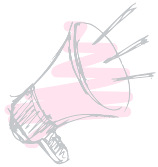
Oftentimes, young companies do not issue bonds, but simply sign loan agreements instead; this is for instance the typical form for bank loans and loans from similar institutions.

However, the underlying economics is unchanged and as you read on, you can think of bonds, loans, and debt interchangeably, but once you get to raising capital you should consult with a lawyer and get a precise understanding of the agreement.

In order to compensate investors for their patience and risk taking, your company can offer a price that is lower than the principal is, but most commonly companies offer interest payments up until maturity instead. Interest payments are calculated as a given percentage (the "**interest rate**") times the principal.

When a bond does pay out interests, it can do so with a "fixed" interest rate, which is set at the time your company issues the bond, or it can use a "variable" interest rate that is determined periodically based on a publicly available benchmark or index eg the Reserve Bank cash rate or CPI.

One example of a variable interest rate could be the interest rate that is determined as the yield on a specific Australian Government Bond plus a fixed premium to compensate the investor's risk taking.


Since the interest rate on the government bond varies over time, this added to the premium will indeed be a variable interest rate. Variable interest rates can be advantageous because they can mimic the overall developments in the marketplace.

Interest payments are typically scheduled quarterly, semi annually, or annually, but in some cases, all accrued interests will be due upon maturity. For historical reasons, the interest on a bond is called the “Coupon”, and when a bond is issued without interest, it is called a Zero Coupon Bond.

A bond can also be offered with a repayment plan such that the principal is paid back in small portions up until maturity. Such agreements are called Amortizing Bonds and the repayment plan is called an Amortizing Schedule.

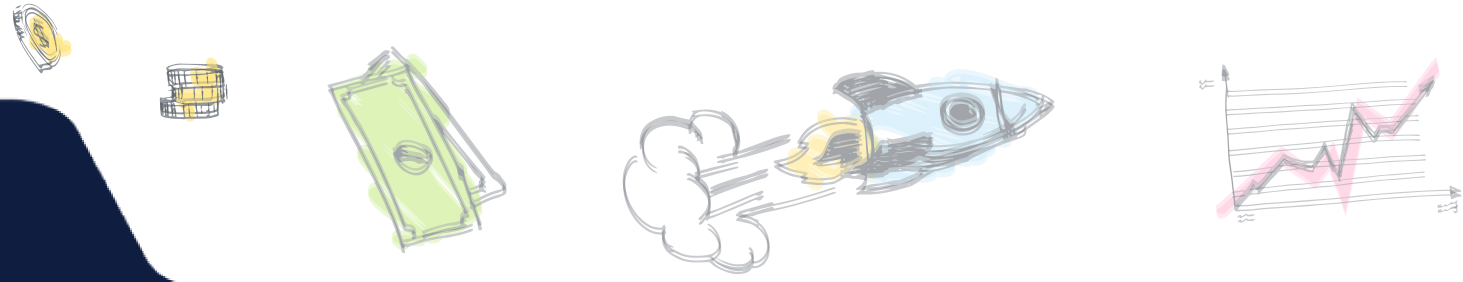
Bonds where the principal is paid back in full upon maturity are also called Bullet Bonds. An overview of the basic jargon about bonds is provided in the table on page 8.

A final important observation is that investors who own bonds are creditors of your company, and as such, they have priority over equity investors.

This means that they are paid out first if the company liquidates. Or put another way, if your company is in distress, its value (if liquidated) is shared among creditors first and equity holders next.

If your company is not in distress and it grows, the value for bondholders is unchanged. For startups, this is very important to understand, because often investors serve (informally) in the capacity of an advisor beyond providing capital, and if you expect that engagement from a bondholder you should be aware that the bond itself does not provide any additional compensation for added value to your company.

There are several ways that you can compensate advisors and we will look at some of these later on.



BONDS JARGON

Principal	Amount of money to be repaid, either all at once on maturity (Bullet Bond) or in instalments (Amortizing Bond)
Maturity	The point in time when the principal must be fully repaid and the bond terminates
Price	The amount of money that the issuer receives initially from investors in return for the bond
Interest (rate)	Compensation paid by the issuer to the bondholder The interest is calculated as a percentage times the principal. Interest rates can be fixed or variable
Bondholder	Investor who owns bonds
Zero-Coupon Bond	A bond that does not pay out interests
Amortizing Bond	A bond where the principal is repaid in installments up until maturity
Bullet Bond	A bond where the entire principal is repaid at once on maturity

Shares

A share represents a unit of ownership in your company. It entitles its owner (the "**Shareholder**") to a share of your profits in the form of dividends, but it does not mean that the shareholder has a right or obligation to partake in your business matters on a daily basis.

They do, however, get to vote at your shareholder meetings where your company's strategies are determined. You will provide a share agreement and certificate that formalise the shareholders' rights to dividends and voting rights.

The main difference between bonds and shares pertains to the distribution of *control rights* and *cash flow rights*. Bondholders can exercise control in cases where the bond issuer does not honour the terms of the loan agreement; eg if the company is in distress. The situation for shareholders is very different.

While bondholders do not have access to financial disclosure and rarely have any formal influence on the companies they are invested in, shareholders do. We refer to these legal entitlements as the shareholders' control rights.

Shareholders only have a claim on the earnings of the companies they invest in if these companies decide to pay out dividends. For bondholders the situation is very different insofar as the repayment and interest schedules are legally binding.

When companies have positive net earnings, but choose to reinvest these rather than pay out dividends, they increase the value of their assets and thereby increase the value of the company itself. This creates value for shareholders, because the value of each share is linear in the value of the company.

If your company cannot service its debt obligations and you are forced to go out of business, your share will be worthless. This is the downside for shareholders: there is no protection against losing the initial investment. For this reason, shares are generally considered riskier than bonds, and the reason they still appeal to certain investors is that these will share in the success if the company turns out to be successful.

At this point, it is important to note how the return on investment differs for shareholders and bondholders: Shareholders share on the upside, but have no protection against downside risk; while bondholders do not share on the upside, but have better protection against downside risk.

SHARES JARGON

Dividends	A portion of your company's earnings that is distributed to investors.
Share	A security that represents a claim on your company's assets and earnings.
Shareholder	The owner of shares in your company.
Cash Flow Rights	Rights to receive dividends assigned to investors in your company.
Equity	The value of your company less the value of your company's debt.
Certificate	A physical document that represents share ownership in your company. Certificates are no longer commonly used and the records of ownership in most companies are kept only in electronic form.
Preferred Shares	A class of shares with enhanced cash flow rights in the sense that a certain preset dividend must be paid out to shareholders with preferred shares before any other shareholder can receive dividends. Preferred shares is usually issued without voting rights.
Founders' Shares	Ordinary shares issued to the founders of the company.

Options

Options differ from bonds and shares in that they are purely financial contracts. They fall in a class of financial assets that we call “derivatives”, because their return and risk structures (and thereby their values) are derived from another asset.

While bonds serve as loan agreements and shares formalise a distribution of ownership, an option is merely a contract that gives the owner the right (but not the obligation) to either buy or sell a specific asset—this is called the underlying asset of the option. For startups the underlying asset is most commonly shares in the company itself. Options furthermore specify the strike price at which the underlying share can be bought or sold.

An option that gives its owner the right to buy the underlying share is called a “Call option” and an option that gives its owner the right to sell the underlying share is called a “Put option”.

If we look at an investor’s return from owning options, we can easily find the relationship between the option’s value and the value of the underlying share.

The return on a put option, which gives its owner the right to sell the underlying share at a predetermined strike price, is given as the strike price minus the (market) value of the underlying share. This is of course only the case if the strike price is higher than the value of the underlying share, because the option holder does not have to exercise the option if it is not viable.

The intuition is straightforward: the option holder can buy the underlying share at the point he/she wishes to exercise the option, and sell the underlying share instantly at the strike price and, hence, net the difference between the two in return.

Looking at this another way, a put option works as insurance against a drop in value, or potentially as a gamble that the underlying share’s price will drop in the future.

The return on a call option, which gives its owner the right to sell the underlying share at a predetermined strike price, is given as the strike price minus the (market) value of the underlying share. This is of course only the case if the strike price is higher than the value of the underlying share, because the option holder does not have to exercise the option if it is not viable.

The intuition is straightforward: the option holder can buy the underlying share at the point he/she wishes to exercise the option, and sell the underlying share instantly at the strike price and, hence, net the difference between the two in return. Looking at this another way, a put option works as insurance against a drop in value, or potentially as a gamble that the underlying share's price will drop in the future.

The return on a call option, which gives its owner the right to buy the underlying share at predetermined strike price, is given as the (market) value of the underlying share minus the strike price. The option will of course only be exercised if the strike price is lower than the value of the underlying share, because the option holder does not have an obligation to exercise the option if it is not viable.

The intuition is very similar to the case of put options: the option holder can exercise the option, buy the underlying share, and pay the strike price. He/she can then sell the underlying share instantly and, hence, net the difference between the two in return.

A call option can provide a big return if the underlying share increases in value, but as long as the value of the underlying share is lower than the strike price the call option is worthless.

In context of startup finance, options are often used to compensate advisors, executives and service providers, and as we will see in the section Startup Funding later on, call options play an important role for convertible notes.

OPTIONS JARGON

Option	Financial contract in which the option writer grants the option holder the right (but no obligation) to either sell or buy the underlying asset/security.
Maturity	The expiration date of the option.
Strike Price	The price at which the underlying asset (or security) can be sold or bought by the option holder.
Option Price	The initial payment by the option holder to the option writer.
Option Writer	The party that sells the option.
Option Holder	The party that purchases the option.
Underlying Asset/ Underlying Security	The asset (or security) that can be sold/bought by the option holder.
Call Option/Put Option	Call option: The right (but not obligation) to buy the underlying asset. Put option: The right (but not obligation) to sell the underlying asset.

PRIVATE OFFERINGS vs PUBLIC MARKETS

When you are fundraising from private investors, you have to prepare yourself and your team for questions that go far beyond financial projections, customer traction, and intellectual property. Highlighting your ability to execute against opportunities at hand and the relevance of your team's combined skills and experiences is far more important than you might think. In fact, many angel investors prefer to invest in people rather than ideas, following the logic that the ability to execute is the most important ingredient for success.

While these traits are important for any company—big or small—investors in public markets reasonably assume that companies are analysed and that their actions are carefully evaluated by outsiders. This means that public market investors tend to focus more on the hard financial data and analysts' recommendations.

News coverage of financial markets are commonplace and most respectable media outlets couple their analyses with a run down of the overall status of the economy. Daily updates on surges and plunges of the dominating share exchanges and indices helps us understand how the economy responds to policy changes and how investor behaviour can help us make economic forecasts for the weeks, months, and sometimes years to come. All of this is possible because investors respond to vast amounts of data about the securities they trade in.

When you raise capital for a startup, you do so from private investors, and there are several very important differences between private and public capital markets that you need to be aware of. The Corporations Act and disclosure requirements, combined with the broad interest from media and analysts, create transparency in public markets.

In turn, this enables investors to comfortably invest in companies without necessarily engaging in any analysis of their own. Private offerings are less

transparent, and they do not receive the same level of analyst interest. This means that investors largely undertake their own due diligence.

If we add up the reduced transparency, the limited opportunities for diversification, and the lack of hedging positions, it should be clear that the capital supply in private markets is comparably scarce. In other words, investors will in general favour a publicly traded security, which makes public markets liquid.

> **"... your exit strategy. How and when will investors be able to realise a return on their investment?"**

This leads us to the final note on private offerings: your exit strategy. How and when will investors be able to realise a return on their investment? For bonds, the answer is simply: upon interest and principal repayment (ie at maturity). For shares, the answer is not as straightforward.

Startup shares are rarely listed on a stock exchange such as the ASX and can have transfer restrictions placed on them, which means the investor cannot freely sell its shares. For this reason, it is paramount that startup investors understand how and when they can expect to see an exit and realise a return on their investment. Commonly, early stage investors will realise a return if the company they invest in merges with or is acquired by another company (this is often abbreviated as an "**M&A**"), and of course in the rare cases where companies are taken public (in an "**Initial Public Offering**" or simply an "**IPO**").

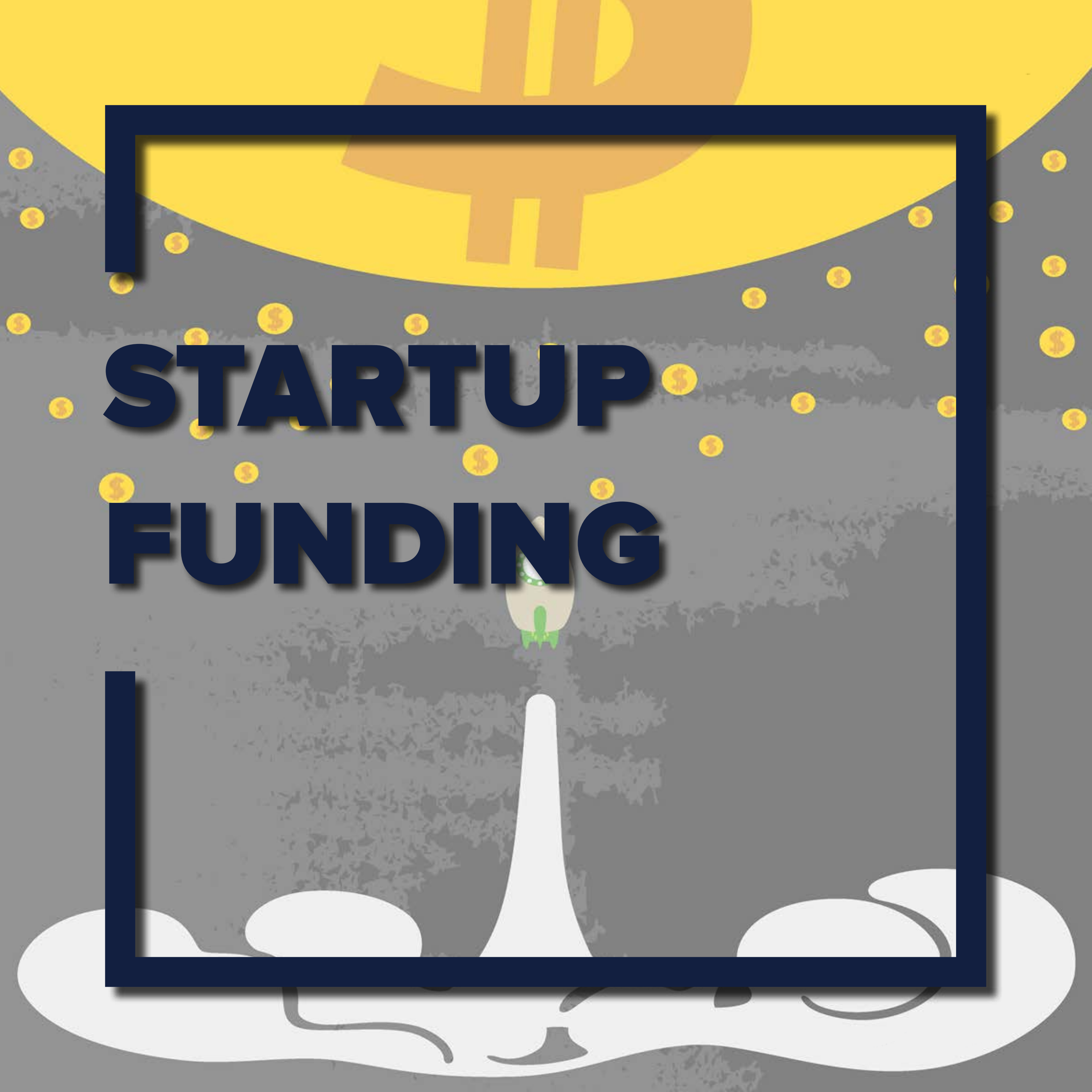
Startups are acquired when they provide a significant strategic value to the acquiring company. Common examples include technology acquisitions and acquisitions where the most important asset is the actual customer base. An important distinction between these two is that technology acquisitions are possible when the acquired company legally owns the rights to a specific technology, ie when it has secured these rights with one or more patents that make the technology proprietary.

Customer motivated acquisitions are very different. There is very little to hinder outsiders from aggressively targeting the startup’s current customers, but such endeavours can be more costly than acquiring the company itself. For that reason, we do see this kind of acquisition especially among Internet companies.

If your exit strategy includes your company being acquired, it is important that you provide details that explain the strategic value of your startup. That is why someone will be interested in purchasing your company in the near future.

Subsequently, you should provide a shortlist of specific companies who might be good candidates for that exit. Another exit strategy involves later stage funding rounds.

If this is your exit strategy, you should highlight the investment activities relevant to your industry and location, and subsequently provide a shortlist of the venture capitalists that you foresee would be interested in your startup.


STARTUP
FUNDING

STARTUP FUNDING

DEBT FINANCE

The major benefit of debt financing hides within the concept of financial leverage: by funding your company with debt you are able to increase its value without reducing your share in it. Consequently, in the end, after paying off your debts, a share in the company will yield greater returns.

The downside of debt financing is that it increases the risk of failure. In fact, most new businesses fail not because they are economically unviable, but because they run into liquidity issues. Any lender (including bondholders) has the right to liquidate your company if you are unable to service your debt.

This makes debt financing a very risky option for companies with volatile cash flows—a category under which most startups fall, especially tech firms.

Investors are fully aware of this risk, which calls into question the availability of quality debt financing for new businesses. Few lenders would give a loan to a startup without a significant interest rate and a guarantor or collateral. Of course, all of this is case specific. If you have a strong background and connections in your field, you might be able to secure debt funding with good conditions.

> **Because of the risk it incorporates, debt is rarely the most prudent funding option for startups, yet there are some cases where it is appropriate.**

Because of the risk it incorporates, debt is rarely the most prudent funding option for startups, yet there are some cases where it is appropriate. Many new businesses get their first round of funding from family and friends and often bonds are a superior security to share in such cases.

Frequently the reason family and friends are willing to finance you is not because they want to invest, but rather because they want to help you succeed. Yet, they might be worried about whether they will ever get their money back. In other words, they are not very enticed by the upside potential and are discouraged by the downside risk.

The characteristics of bonds perfectly fit such a situation and provide a solution. Moreover, by issuing bonds instead of equity, you can avoid the problems of giving up control to people who are not competent in your field or having to determine the value of your company at an early stage.

Lastly, because of the higher level of trust in the relationship, family and friends are more likely to agree to restructure the loan in cases of liquidity problems.

Bridge funding between larger funding rounds is another case where issuing bonds could be the best option. If you have short term liquidity problems and need a small amount of money to pay the bills until you secure proper funding, issuing share might be too costly and slow for your purposes.

Of course, as is always the case with debt financing, you need to have a certain degree of confidence that you would be able to repay the loan.

Funding a startup through equity instruments is by far the most common option because investors understand the high risk nature of the investment and are most interested in sharing in the upside potential of the company.

Since funding with equity is equivalent to selling a share of the company, the most important issue at hand is putting a fair monetary value on the business.

Many will agree that company valuation is more of a relative rather than an exact science because it always includes assumptions about the future. Valuation methods start from “instinctive” at

at one end of the spectrum and reach "quantitative" at the other. If you are at a very early stage and have no financial data, you will have to rely more on "instinctive" methods.

Examples include comparative analyses of the performance or the recency and size of the exits of similar startups. Combined with the growth and saturation of the industry you are in, creating valuations via proxies is often the best you can do.

If your company has revenues and has a financial history, you can use more accurate and quantitative methods. The most commonly used method is cash flow projections based on past performance.

To determine what percentage of the business your investors should receive in return for their money you also need to understand if the agreed value of the company is prefunding or post funding — ie if the value includes the invested funds. The post funding is the one from which the investor would want to calculate his share.

An important concept to grasp when considering funding through equity is that of dilution. It simply means that by issuing new company shares, you reduce the value of the ones you (and other owners and investors) are currently holding.

You own a smaller percentage share of the business and as a result are entitled to a smaller percentage of the earnings and the proceeds of an exit. The goal is to negotiate funding conditions in which the overall value grows accordingly (or in excess) of the percentage you are giving up.

For example, if you currently own 50% of a $1 million business, your personal value is $500,000. You find funding that allows you to

"Valuation methods start from "instinctive" at one end of the spectrum and reach "quantitative" at the other."

reach a post funding valuation of $5 million in exchange for 50% of the whole company. Your stake is diluted by 50% because your share in the business becomes 25%.

Nonetheless, 25% of $5 million is $1.25 million – your personal value grows by $750,000. This is the good case scenario.

In the bad case scenario, it is possible that the new funds do not help you grow your business (eg you invest them in promotional activities that do not yield results). In that case, you own 25% of the same business ($1 million and overall your value has decreased by $250,000.

CONVERTIBLE NOTES

A funding option exists that does not require you to choose between the pros and cons of debt and equity. The convertible note is a type of bond that the bondholder can convert into a specified number of shares in the company that has issued the financial instrument. In that sense it works like a package of a bond and a call option: the investor receives interest and principal payment with the possibility of acquiring equity in the company at a certain point in time (at maturity).

An investor holding a convertible note has the opportunity to share on the upside by exercising his option to become a shareholder.

Furthermore, he/she is protected against downside risk by the loan characteristics of the note—the principal and interest are payable at maturity if the investor chooses not to convert.

The convertible note also holds advantages for the issuer of the security: although it is a debt instrument, it motivates investors to contribute advice or connections as they can potentially share on the upside.

Moreover, the interest on a convertible note is expected to be significantly lower than on a traditional bond for the same reason.

If you finance your seed stage with convertible notes, you postpone the need to determine the value of the business for a later point in time, when you are expected to be able to make a more accurate valuation with the financial data you possess.

This way you are able to put a more accurate price tag on a percentage of your company in addition to postponing the problems of dilution and giving up control.

Convertible notes have three main mechanisms to protect investors and reward them for the risk they are taking:

- interest;
- discount; and
- conversion cap.

If you finance your seed stage with convertible notes, you postpone the need to determine the value of the business for a later point in time

Convertible notes usually require the note writer to pay interest at a simple annual interest rate. Instead of paying regular instalments, the interest accrues and is paid in total together with the principal at maturity or is converted into shares of the company.

The conversion discount rewards the note holders for taking risk by giving them the right to convert the principal plus interest into shares at a lower (discounted) price than the valuation at maturity.

For example, if the discount is 20% and the valuation of the shares at maturity is $1.00, the investor would be able to convert the loan into shares at a price of $0.80 per share, ie the note holder would be able to convert a $100,000 loan (principle plus interest) into 125,000 shares, while another investor would have to pay $125,000 to acquire the same percentage of the company.

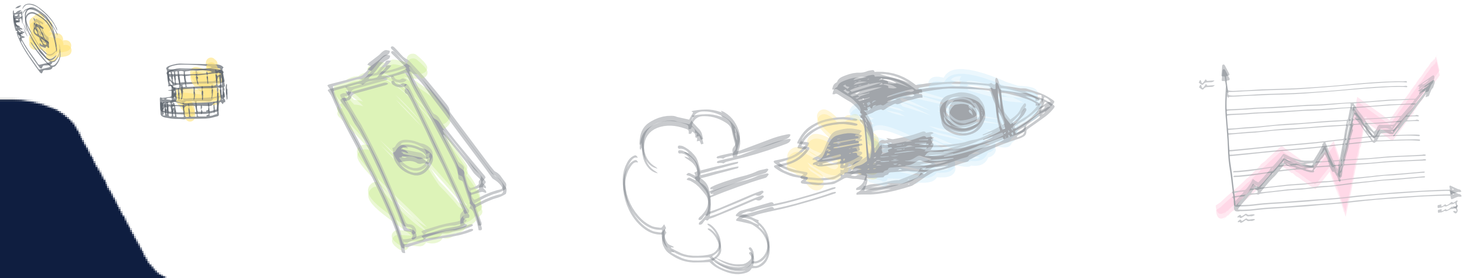
The simplest type of convertible notes are “discount only”, but they have serious limitations for investors when it comes to sharing on the upside.

Continuing the example above, the investor in question would receive $100,000 worth of shares regardless of whether the value of the company was $500,000 or $10 million. The higher the valuation, the fewer the shares the investor receives.

This is the reason why there is an argument that “discount only” notes penalise investors for their efforts in helping the startup grow in value. The conversion cap is the mechanism designed to tackle this problem. The cap represents a theoretical ceiling of the value of the company at maturity.

Returning to the example above, a conversion cap of $1 million and an actual valuation of $5 million means that the note holder would be able to convert to shares as if the valuation were $1 million. The $100,000 loan would in this case convert into 10% of the shares, which actually is worth $500,000.

Consequently, the most common convertible notes have both a discount and a conversion cap and note holders can choose which one of the two mechanisms to use at conversion—the one that yields a lower price per share.



FINANCIAL INSTRUMENTS: Convertible Notes

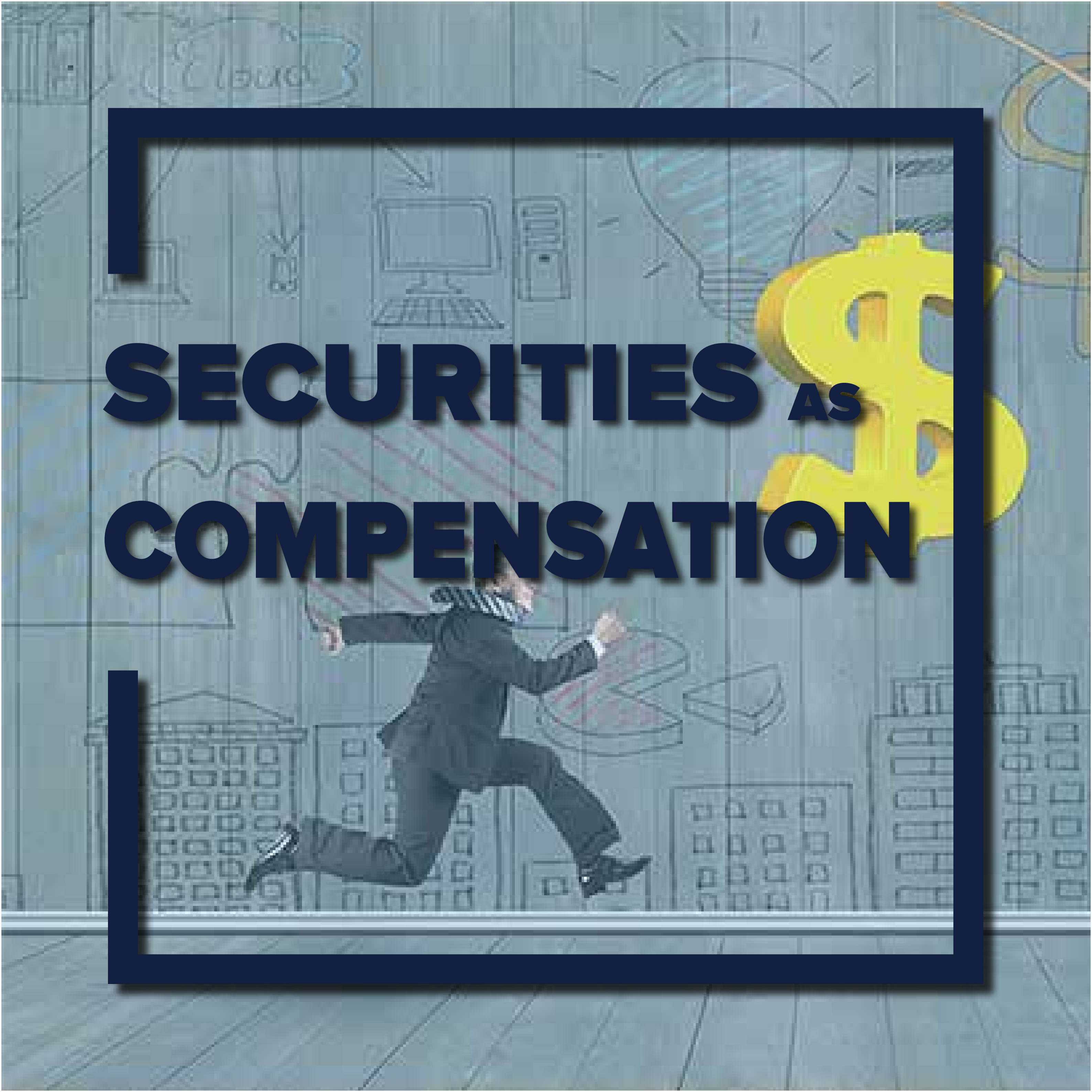
Convertible Note
Financial contract in which the note holder gives a loan to the issuer and either receives principal plus interest payments or converts the loan into shares of the issuing company.

Maturity
The expiration date of the note at which the loan has to be repaid or converted into equity and the financial contract is terminated.

Interest (rate)
Compensation paid by the issuer to the note holder. The interest is calculated as a percentage times the principal and is usually accrued and paid together with the principle at maturity OR converted into shares.

Discount Rate
The discount of the share price that the note holder receives at maturity if he/she decides to convert the loan into equity.

Conversion Cap
A theoretical ceiling of the value of the issuer company at the maturity date used to calculate the price at which the note holder can convert the loan into shares.


SECURITIES AS
COMPENSATION

SECURITIES AS COMPENSATION

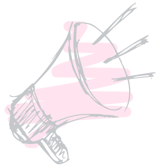
The basic goal of using securities as compensation is simple—to align the interests of the shareholders of the business with its employees. The underlying logic is not very different from that of any other type of variable pay (eg sales commissions). If growing the business and making it more successful, thus increasing the value of its shares, brings personal benefits to the employees, they are more likely to work harder towards achieving that goal.

> **Australia's tax laws have made it simpler than ever before for startups to set up employee share option plans**

Consequently, giving securities as a form of compensation to the management team (the decision makers in the business) or any other employee whose work is likely to have a major impact on the success of the business is a relatively common practice.

The main disadvantage of securities as part of a compensation plan is that setting them up is quite complicated. There are a lot of laws and requirements that have to be taken into account; tax considerations, accounting considerations, corporate law, securities law, and on top of that, they bring the usual complications of equity instruments: pricing and dilution. That said, Australia's tax laws have made it simpler than ever before for startups to set up employee share option plans with safe harbour valuation methodologies and pro forma plan rules.

Creating an appropriate vesting schedule and protections for the company and security holder under certain circumstances (eg sale of the business) is also crucial. Legal services are necessary if a company wants to offer securities as compensation.


VESTING SCHEDULES

Likely, the most important to understand feature of equity based compensation are the vesting terms. These are the conditions that the security holder needs to meet in order to collect the benefits from the compensation plan.

Since the security holder is most often an employee and the goal of the company is to keep the employee working hard for at least a few years, the vesting terms usually state that the employee must have worked a certain amount of years for the company in order to claim these benefits.

Constructing a more complicated schedule is also possible eg by releasing certain benefits when the employee's performance meets preset benchmarks.

The main goal of having such a mechanism is to prevent a case where the security holder uses the first occasion to liquidate the securities and leave the company.

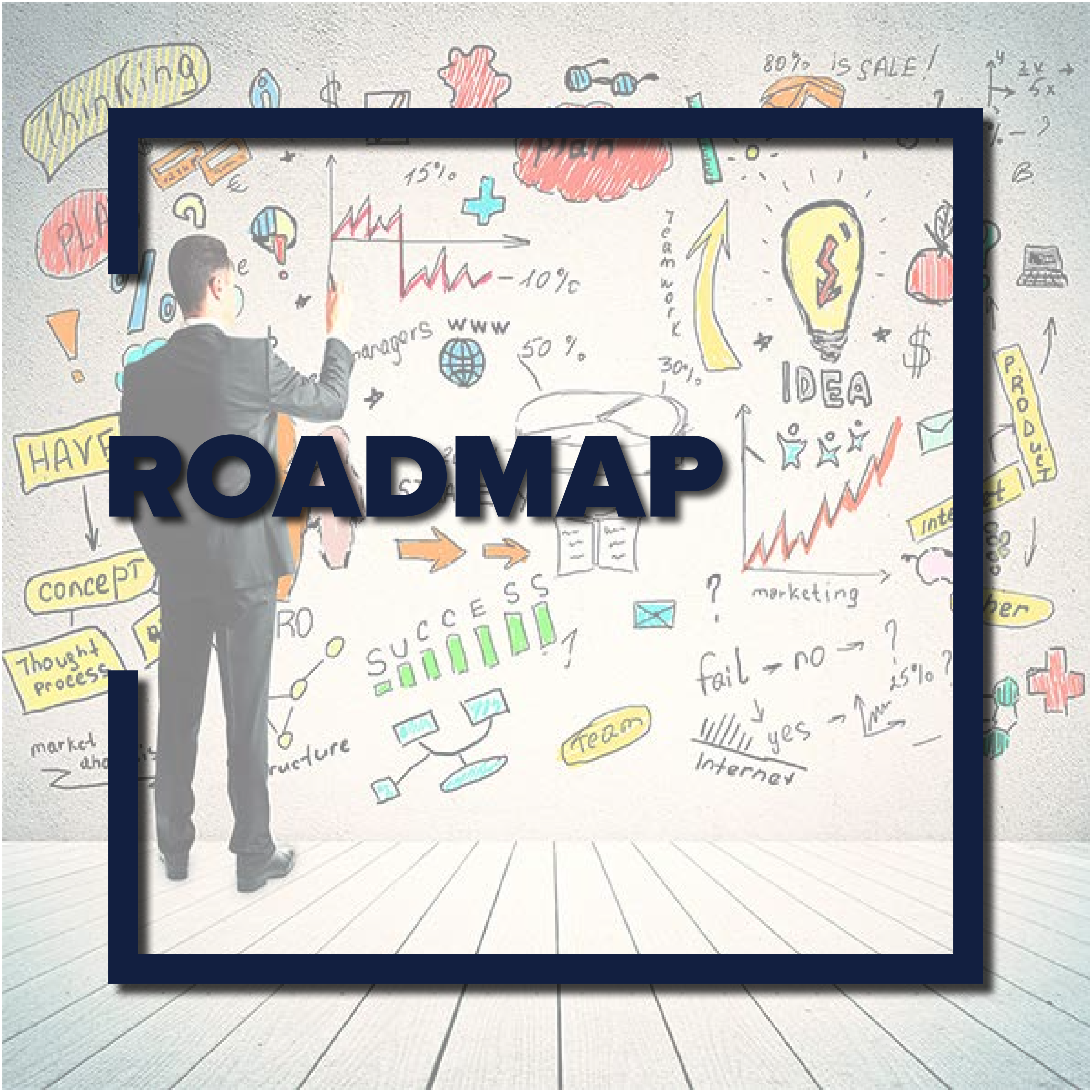
WHEN TO USE SECURITIES BASED COMPENSATION

Securities based compensation plans give startup companies a great tool to reward core employees for their work and to attract specialists.

As the company grows, however, the costs of offering equity compensation might start outweighing the benefits and offering a more traditional fixed and/or variable compensation usually becomes the simpler and more financially reasonable option.

Security compensation plans for the upper management of the company are always reasonable, even for a mature firm, but the vesting terms need to be very carefully tailored to fit the conditions and environment of the business, otherwise the compensation plan could create problems and conflicts rather than align the interests of management and shareholders.

We cannot emphasise enough that securities based compensation plans have to be tailored to the specific needs and expectations of the issuing company (such as yours). This is not where you want to use “cookie cutter” templates or off the shelf contracts.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80% is SALE!
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ROADMAP

In this eBook, we have introduced you to the basic finance vocabulary related to startup finance. We have explained how the three basic financial instruments (bonds, shares, and options) work, and how they distribute control rights and cash flow rights between your company and your investors.

From there on, we have explained how the most common startup securities will affect and incentivise your investors, and continuing from there, we went on to talk a little bit about securities based compensation. Now you need to figure out what all of this means for your company.

Before you issue securities, you should seek legal advice. The main reason is that you need to make sure that the securities you issue reflect the relationship you want to build with your investors.

Do you expect your investors to play an active role in your company? Will you need to compensate current/future team members with securities? What are your funding needs? What types of securities should you issue—and when?

These are all questions that you should explore, and when needed, discuss with legal counsel. We have summarised the most important aspects of these questions here below.

PASSIVE VS ACTIVE INVESTORS

When we discussed debt financing, we saw that the bond as a financial instrument does not provide any incentive for the investor to actively participate and assist you, unless the company is in distress.

As a startup, you probably need investment capital today as well as access to additional capital in the future, and to that end, a security (like the bond) with a flat return structure is a bad fit.

Shares and convertible notes can provide those incentives, but if you need ongoing advice, you can formalise that in an actual agreement. In these cases, you can simply offer securities based compensation as if the investor is also a team member.

SECURITIES BASED COMPENSATION

Using equity based instruments like shares or options as compensation for involvement in the business is the most commonly used way to align the interests of the holder of the security and the owner(s) of the company. The holder could be any person that the owner(s) wants to incentivise to work towards the success of the business—an employee, manager or active investor.

In the startup world building an option plan serves not only as a way to make people work harder but such a plan is also a great tool for involving professionals with valuable skills, experience and know-how that the entrepreneur cannot afford simply by offering a traditional fixed salary. The most valuable asset of a startup is the promise of the potential it holds. It makes sense to use this value in attracting and motivating the right people who can realise this potential.

FUNDING NEEDS

Choosing the right startup securities would not matter if the calculations of the funding needs of the business are wrong. In order to avoid financial problems you need to make sure you understand the financial needs of your business well:

1. **Capital Investment:** What kind of tangible and intangible long term assets does the business need in order to reach its potential and how much capital do you need in order to acquire or create these assets?

2. **Working Capital:** What are your operating costs and how much funding do you need in order to cover them until the business starts supporting itself?

Create a plan for dealing with contingencies is also important, otherwise short term liquidity problems could take you out of business before

you have truly tested the viability of your business model. It is a good idea to create a reasonable worst case scenario for your cash flows and to make sure you have enough funds to survive or at the very least, create a plan on how to deal with potential problems.

TYPES OF SECURITIES AND FUNDRAISING STRATEGY

Calculating how much money your business needs does not guarantee that you will be able to find all of it right away. The actual fundraising is usually a problem in itself and you need to have a strategy in order to tackle it successfully.

Who are your best fundraising prospects? How will you attract investors? What are your goals, what are your estimated returns? What kind of securities fit your needs best? How much time do you need to raise your funds and how would you survive until then? Do you need to break the process into stages? The typical route for startups looks like this:

- Offer convertible notes to avoid pre revenue valuation.
- Take first product/service to market.
- Use the initial market traction to evaluate the potential of the business and attract bigger investors. Offer them preferred shares so that they are more likely to invest.
- Use bonds to tackle short-term liquidity problems in order to avoid further dilution.

As you can see, using a mix of shares, bonds and convertibles can be the best way to exploit the characteristics of the different securities to your advantage depending on the scenario.

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