FINANCING STRATEGIES FOR START-UP COMPANIES

Introduction:

Early stage companies generally when projecting rapid and expansive growth need excellent legal advice but have very little funds to pay for such required advice. The following legal matters need to be handled at a minimum - and should keep the fees down:

- Getting the corporation formed and the founders' stock issued. Some additional documentation may be needed at this stage such as option agreements, benefit matters, employment agreements and such but these should be kept at a minimum until the financing strategy can be developed and some funds raised.

- Make certain that the technology is protected, and that the non-disclosure agreement program is implemented for employees, etc.

- Very little else can be provided by counsel at this stage other that provide advice and guidance until it is reasonably clear that the financing strategy can work. Introductions can be made through the lawyer's contacts to venture capital and investment bankers that might be interested in the type of company. There won't be any securities problems since there won't be any offered or sold yet.

Documentation:

What documents need to be used to seek investors and what is the lawyer's role in preparing the documents? There are two basic types of documents used to raise private capital from investors - the business plan and the private placement memorandum.

- Business Plan: The business plan is the statement of strategy generally drafted by the entrepreneur in simple, non-legal language. It is used to solicit venture capital funds (generally not less than $500,000) and should communicate how the key manager and entrepreneur thinks rather than being a pure disclosure document. The lawyer should generally correct improper statements and can assist the entrepreneur by showing him what should be covered in the plan, but the plan should not be written by the lawyer.

- Private Placement Memorandum: The private placement memorandum is a lawyer drafted document generally used as a disclosure and solicitation document for raising money from a number of smaller investors (doctors, etc.) or for a larger institutional placement to insurance companies, institutional investors, etc. This type of document can cost anywhere from $10,000 to $25,000 for most companies in legal, printing, accounting fees and costs.

Finding Investors:

There are a number of possible sources of capital for smaller companies as they are starting-up, but none of them are necessarily easy to convince that money should be invested in a particular venture. The following is not a complete list but should provide some food for thought on forming a capital strategy.

- Early Stage Investors: Practically speaking, the most ready source of capital to the entrepreneur afte he has exhausted his own funds are relatives and friends. Their commitment to the investment is more likely to result from a sense of friendship or obligation than the investment potential, rate of return or prospect of capital appreciation. If the entrepreneur has sufficient resources, bank loans and SBA loans are also a source (although not much in Oklahoma in the last few years). Additional early stage sources can be suppliers and customers; licensing, marketing or manufacturing arrangements; and in rare instances - professional "seed funds" (again, not much in Oklahoma). On rare occasion, a venture capital group my put up some seed money for additional development work to see if it is worth investing in a "Round I" type financing.

- <u>Venture Capital/Private Equity Funds:</u> It is important to identify the kinds of deals that a venture capital or private equity fund looks at, the regional preferences and the amounts of money that it is willing to commit (both minimum and maximum). The company's lawyer, accountant or adviser may be able to make introductions to different funds. Once identified, it is important to get honest feedback as quickly as possible. If the company is viewed as unfundable, it is critical to find this out ASAP to avoid additional expense and redirect its capital strategy.

  There are advantages and disadvantages to venture capital and private equity investors. Some of the advantages are that they are smart investors - you gain a financial partner who has a track record helping to build companies and will help the company succeed. They have deep pockets and can produce more money if it is needed. They also have the patience and know how to live through hard times with a company. They are generally easier to deal with that a large group of small investors which means the entrepreneur can spend more time running the company and less time "hand holding." The fund will often produce better valuations in the IPO or subsequent rounds of financing. Some of the disadvantages to going with a venture capital or private equity fund are that the fund will usually get more of the company for less money than many other sources of capital (in many instances control or a right to gain control). Since the fund is a sophisticated investor it will tend to assert a lot more influence, especially where the company fails to meet its financial projections and milestones, than other types of investors.

- <u>Brokerage Firms:</u> Another source of financing is through a brokerage firm raising capital through a private placement to individuals or institutions. Like venture capital funds, brokerage firms may have size and geographic requirements and well as industry requirements that may limit the choices available. Brokerage firms will also tend to shy away from private placements less than $500,000-1,000,000. Few firms will sell a private placement on anything but a best efforts basis which means that they may commit to try and sell the deal, but if they can not, the company may have spent the money in vain.

- <u>Corporate or Institutional Partners:</u> Whether through a brokerage firm or direct introductions to the institutions, these types of investors can be good for the company if it can interest them in the investment. They tend to be long term investors, can provide the same type of support that a venture capital fund provides.

- <u>Going Public:</u> Rarely can a start-up or early stage company convince a brokerage firm to do an initial public offering ("IPO") of its stock. The exceptions are when dealing with a local or small regional firm that has done similar offerings in the past or has worked with the entrepreneur in another offering and is convinced that he can do it again. Denver, Salt Lake City and Vancouver have in the past produced a number of small brokerage firms that raised $500,000 to $5,000,000 in the "penny stock market" for unseasoned companies. Most of these firms are now out of business.

Valuation:

It is frequently helpful to develop some financial assumptions and show in tabular form what the various financings mean to the company and the entrepreneur. A primary concern to the entrepreneur is to retain control of the company which often means trying to reeducate him on what the values are in the company if capital can be provided and that control does not necessarily mean owning 51% of the stock. The following table is a helpful example of the various financing rounds for a company that ultimately goes public and what that means to the entrepreneur:

Shareholders	# Shares	Price	Dollars	Valuation	Pct.
Founders	2,500,000	$ 0.01	$25,000	$ 25,000	25%
Seed Investors	500,000	0.20	100,000	600,000	5%
Round I Inv.	2,000,000	1.00	2,000,000	5,000,000	20%
Employees	1,000,000	0.10	100,000	6,000,000	10%
Round 2 Inv.	2,000,000	2.50	5,000,000	20,000,000	20%
Employees	1,000,000	.25	250,000	22,500,000	10%
Public	1,000,000	15.00	15,000,000	150,000,000	10%
TOTAL	10,000,000		$22,475,000		100%

As seen from the table, while the founders end up only with 25% of the company, their stock does have a market value of $37,500,000. They still have the largest single block of stock and in all likelihood, control the board of directors!

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