Article Outline

Topic: Startup Funding: Types, Rounds and How to Raise.

Importance: why is discussing this topic important?

The number of startups in Nigeria was pegged at 3,300 in 2020[1], the highest number in Africa. The advent of technology in every sector of the economy has paved the way for an average Nigerian to indulge in building scalable tech startups in record time. Building a successful start-up is capital intensive and raising of funds from VC firms and Angel Investors is often the route taken by founders. This topic educates founders and readers about the intricacies of fundraising, the types of fundraising rounds and how to successfully raise funds without raising red flags.

1. **What is Fundraising?**

Startup fundraising otherwise known as startup capital is the money needed or raised by an entrepreneur to launch or scale a business. Depending on the stage of the business, the entrepreneur can search for funds from several sources including investors, grants, loans or other forms of funding to hire new employees, cover operational expenses or refine its business model to scale the company. At the startup phase, when the entrepreneur is wet behind the ears, fundraising can be both exciting and challenging. The need to continuously build the product to meet your target market demand requires funding, but without the needed experience to navigate fundraising, getting funded may become challenging.

Statistics has shown the decline in the funding of startups around the world. Global venture funding hit $437 billion in Q3 of 2021[2]. The ecosystem recorded a 23% funding decrease pegged at $108.5B in Q2 of 2022[3] making it the biggest quarterly percentage drop in a decade. Startups in Africa scarcely raised $300 million between April and May 2022 as against $1.8 billion raised in Q1 2022[4].

So how do you navigate the ecosystem and get funding for your startup?

2. **Types of Funding**

Unless the founder is a trust fund "*baby",* chances are high that you will need some sort of financing to launch or scale your business. There are two broad categories of financing adopted by business to finance their business models – debt and equity financing.

a. Debt financing involves the borrowing of money from an outside source with the promise to pay back the principal sum and interest. The borrowing company or entrepreneur will provide collateral as reassurance of his commitment to pay back the principal sum and interest to the lender. Debt financing includes loans obtained from traditional financial institutions. The downside is the risk attached in terms of the interest rate and the collateral demanded. Startups

[1] Statista, 2020
[2] Hubspot, 2022
[3] CBINSIGHTS, 2022
[4] Business Insider Africa, 2022

should assess the risks attached to potential loans. Startups must work with lawyers with industry expertise and experience for the purposes of documentation and due diligence involved in loans.

b. The second category of financing is equity financing. It involves the selling of stake or shares in your company to potential investors in exchange for funding. The entrepreneur is under less pressure because they are not liable to pay back the money in instalments or deal with unfriendly interest rates. The investors are interested in future profits of the business by owning portions of the company's profits, and seldomly voting rights, depending on the terms sheet of the fundraising round. Types of equity financing includes:

   i. Angel Investors: These are high-networth individuals who invest in businesses with strong business model. They take up equity in the startup or convertible debt. They are often not involved in the daily routine of the company. They provide fund and expect returns on their investment at the agreed time.
   ii. Venture Capitalists (VC) Firms: This is an entity with its structure populated by individuals or groups that invest in high-risk startups. If the entrepreneur is looking to raise high volume of funds, VC firms are the best to approach with a solid business plan and proof of concept.
   iii. Accelerators: Startup accelerators offer capital funding and support for startups. They organise programs, bootcamps and mentorships to assist founders in achieving their business projections. They may or may not take up equity in your startup.
   iv. Crowdfunding: Also known as equity crowdfunding. It provides the opportunity to entrepreneurs to sell certain percentages in their companies to numerous (individuals) via crowdfunding. Crowdfunding involves fundraising by collecting small, individual contributions from a large pool of donors. For instance, the entrepreneur can sell 20% stake in its business in exchange for a certain amount pooled from numerous investors who are willing to invest in the company.
   v. Grants: States and Federal governments, and some foundations in Nigeria provide opportunities for entrepreneurs to pitch their businesses for possible funding. Entrepreneurs can look for these grants as they come with no pressure and little or no risk.

c. The third and often less preferred is Bootstrapping. This involves the funding of businesses with the personal money of the founder, family or close friends. This help founders keep control of their businesses because they don't have to give out equity or pay interest on loans. It is least preferred because it may be difficult to maintain operational cost and scale a startup entirely bootstrapped.

So as a founder looking to raise fund, where do you start from?

3. How Does Startup Funding Work?

Let's assume that you are the founder of a startup. You have strong believe in your product and now need to hire people to scale your business which is capital intensive. Seeking outside funding can be confusing to newbies in the ecosystem.

Before engaging in the several funding rounds, the **company's valuation** must take place. The valuation of a company is the evaluation of the company's management strength, maturity, market size, proof of concept, profit, risk, and possible impact in the market. The evaluation is put into context when determining the amount to be raised or the fundraising round the startup is at.

Once the valuation is complete, startups can begin the appropriate funding round as discussed below:

a. Pre-seed Funding
This is the earliest stage of funding available to the company. It is regarded unofficial because it involves the use of the personal savings of the founder or funds from family, friends, supporters or close network without demanding for equity in the company or interest on the money loaned. Companies with strong business model that can hit the ground running do not spend many years at this round before being seed funded.

b. Seed Funding
This is the first official fundraising round. Companies in this round, where it is a tech startup, have a minimum viable product (MVP) to give evidence to its proof of concept, traction and may or may not have generated income. Funds raised are usually applied to product research, launching the MVP, and/or marketing to its target audience. It is at this stage that the founder is expected to bring all the necessary personnel onboard to form a perfect team to scale the company to the next stage.

Seed funding may be sourced from angel investors, incubators or some VC firms ranging from $3 million to $6 million

c. Series A Funding
This comes after the seed funding. Once the company has successfully launched its MVP, gain traction in the market, and generated revenue, it can push for Fund A raising. Often post-launch, startups discover gaps in their product and/or business model that needs to be improved on. These usually requires an extra cash injection to successfully pivot or scale further. Funds raised at this stage are used to expand product offerings for deeper market penetration, acquire and improve customer retention, and expand into other territories, where plausible.

Funds raised may be sourced through VC firms, angel investors and or crowdfunding ranging from $2 million to $15 million

d. Series B Funding
Startups at this stage are more focused on business development. They use funds raised to execute possible partnerships, boost sales, and hire new talents. They have high valuation with a solid business model. They are able to attract VC firms to invest in this round averagely valued at $33 million and above.

e. Series C, D and Beyond
Companies at this stage are often Unicorns. Unicorns are companies valued at $1 billion without being listed on the stock market. Every tech startup envisions to achieve the unicorn status, the reality is less than 1% will achieve the status.

Companies raising at this stage need the final cash injection before an Initial Public Offer (IPO) or to achieve an outstanding business goal from the previous rounds. They have an established customer base, track record, and revenue streams. They easily raise funds from hedge funds, investment banks, and/or private equity firms.

4. Conclusion

There is no hard-and-fast rule to fund raising. The devil is in the details; hence, founders are expected to work with industry experts during any of the fundraising rounds. We recommend the following steps in your fundraising round:

a. Determine How Much You Need: The first step is ascertaining how much you need to kickstart or scale your business. Hire the right personnel to determine your runway to profitability and the amount needed to sustain the business for the period. Consider angel investors or VC firms where you need a relatively large pool of funds to run your operations. Traditional banks or grants might make more sense for small amount of money.

b. Have a Business Plan: Investors always request to see a business plan before investing in your business. It is advisable to have both the business plan and a pitch deck. The business plan contains the team, roadmap of the company, target market, marketing, revenue model, funding required and the financial projections. The pitch should be populated with your product features, competitive advantage, SWOT analysis, and the funding required, amongst other things. These two documents would give your pitch a solid outlook when approaching a potential investor.

c. Decide on the Appropriate Funding: It is important that entrepreneurs research and understand the type of funding they opt for to sustain or scale their business. We recommend engaging lawyers with industry expertise and experience when approaching potential investors, so you don't make any fundamental error. We recommend that shares, during a fundraising round, are allotted in numbers and not in percentages to investors. Always speak to your lawyer throughout the fundraising round.

Oluwatobi Ibiyemi
Author