TEN CAPITAL NETWORK

eGuide

Family, Friends, and Other Funding Sources

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PART I: Family and Friends

Funding From Family and Friends

Your Family and Friends

During their first round, many startups raise funding from family and friends to get the business up and running.

Those who are considering family and friends funding need to consider the type of investor they need and ensure that investor profile is met.

The person should have sufficient money and be able to lose some of it with no impact on his or her lifestyle.

It is also important to think about how well connected the potential investor is:

1. Can they help make a deal with a key customer?
2. Do they have industry or domain expertise?
3. Do they have startup or business experience?
4. Are they an accredited investor?
5. Are they an active or passive investor?

These are just some of the questions you'll need to answer to know if they are a fit for your deal, but the above is a great start to finding an investor match.

Should You Take Money from Family and Friends?

One of the top questions startups tend to ask is:

Should I take money from family and friends to fund the business?

The general answer is:

Yes.

Outside investors will look at family and friends funding as a sign of support for your business; this is always a plus when you're seeking additional funding.

Consider it from the investor's perspective:

If your family and friends won't invest, why should the outside investor invest?

The problem is, many startups are reluctant to take family and friends funding because they fear the awkwardness of what happens if things don't work out.

In addition, the valuation is sometimes an issue. A lot of startups give their family a special valuation simply because they are family.

This becomes a problem later when raising follow-on funding from outside investors. You have to give them the same valuation or higher, or your family loses their equity position.

The best thing you can do is take family and friends funding as a show of support. Take that support only as a donation and only in $10k amounts from each person.

When taking the donation, offer to pay them back by supporting their project in the same way when the time comes.

Accepting Gifts

When raising funds, consider that most family and friends want to help you out rather than make a return.

A gift is an ideal way of accepting funds without going through valuations, loans, and other funding mechanics.

Tax laws allow anyone to gift up to **$15k** per year, without triggering gift tax which can be as much as 40%.

While the IRS has established the $15k basic limit per person, wealthy gift givers can choose to exceed the annual limits and gift more money up to a total of $ 5.3 million.

However, one thing to note before accepting a funding gift is that it's not a good idea to gift the funds directly to the startup. The IRS expects that in exchange for the money, the gift donor would normally receive stock in the corporation.

Before Launching

While a lot of startups raise funding from family and friends on their first round there are a few things that need to be taken into consideration in order to be successful.

Before launching, make sure you have the following in order:

1. Co-founders should agree on the equity split for each one and document the ownership agreement legally.
2. Intellectual property (IP) needs to be assigned to the startup. This includes:

- programming code
- product designs
- product trademarks
- domain names

3. If you are hiring employees you need to establish a stock-incentive plan to enhance their compensation package.
4. You are accepting investment funds so you need a legal entity. You'll need to set up either an LLC or a C-Corp.

For an LLC, you give membership units for an LLC, and shares for a C-Corp.

5. You are starting a business, so you'll need a business bank account. For this you'll need a Federal Tax ID (also called an EIN) to complete the process.

Loans from Family and Friends

Taking a Loan

Many startups use loans to fund their business; it’s a common way to get things started. However, if you are taking a loan from family and friends here are some points to consider:

1. Determine the amount of the loan and how it will be disbursed to the startup.

For example, there are time-based disbursements. In which the startup gets something such as:

- $20,000 now
- $20,000 in 3 months
- A final $20,000 3 months later

There are also milestone based disbursements in which the funds are disbursed when the startup reaches specific milestones or goals such as prototype complete, product complete, and customer sold.

2. The loan should be made to the startup and not the founder.
3. You want clear dividing lines between the assets of the startup and the personal assets of its founders. Combining personal assets with those of the startup is a bad practice.
4. Avoid no-interest loans and establish an interest rate of at least 3%.

If you set up a no-interest loan, the IRS will assume an **imputed interest rate** and tax the lender on an **assumed** amount of interest income received.

5. Determine if a personal guarantee and/or collateral are required.

Most startups don’t have assets aside from the intellectual property (IP) created by its founders and employees so collateral is usually limited.

A personal guarantee states that the entrepreneur will agree to be liable for repayment of the loan if for some reason the business cannot make the payments.

Paying off the Loan

After using a loan to fund your business, it is important to make sure you pay the loan back. Here are a few ways to set up a payment structure and schedule. For payment structure you can use:

1. **Interest-only payments**

In the beginning, the startup only pays out the interest and later pays the original loan.

2. **Deferred start of payments**

You may consider starting payments 6 to 12 months after the loan is taken to give the startup time to build product and close customers.

3. **Pay back when you can**

This is the easiest of all payment options which gives the startup a lot of freedom in paying back the loan by deferring the start to some date in the future.

You will need to determine how much will be paid when the payments start so you can create an amortization schedule.

Once you've decided on the loan amount, the interest rate, term, and payment schedule, you can plug those numbers into an amortization calculator to create a schedule of payments needed over the life of the loan.

Profit Sharing

Profits and Shares

Many startups use profit sharing to fund their business. Since this is a popular method of funding, it is important that everyone involved has a very clear understanding of how **profit** is calculated.

There are three locations in the startup's profit and loss to take out a **share** and pay back an investor.

They are as follows:

1. **Top-line revenue**

Top-line revenue is the most often used.

2. **Gross profit**

This is the revenue minus the cost of goods sold or what it cost to make the product.

3. **Net profit**

This is the revenue minus the cost of goods sold and expenses.

Payments and How Much to Share

You must first build a financial model in order to know how much profit to share.

Another key issue to think about is when to start payments to the investors.

1. You could set a timeframe such as 3 to 6 months out, or upon closing a customer sale.

2. You could set a specific amount of revenue or profit or whenever you are able to payback.

Keep in mind, there needs to be a limit to the amount of profit sharing within your business. For example, this can be a specific dollar amount or a time limit.

Equity

Selling Equity to Family and Friends

Using Equity is a great way to fund your business.

Equity is an ownership stake in a company.

Equity:

1. Aligns everyone's interest in the startup.
2. Preserves cash since it's only paid upon the exit of the business.

Startup valuations are noted in pre and post-money figures and helps determine the investor's equity ownership.

1. **Pre-money**

This is what the company is worth before the investment.

2. **Investment**

This is how much the investors are putting in.

3. **Post-money**

This is pre-money plus investment.

Investors own an equity percentage equal to the investment divided by the post-money, however you can also calculate ownership by using share prices.

The share register of the startup should log how many shares have been issued to investors and other stakeholders.

To determine your percentage ownership for your startup, divide the number of shares you own by the total shares issued.

Preferred and Common Shares

Preferred means that the holder receives certain rights or preferences with their shares. These rights provide the preferred shareholder protections, such as getting paid back first before common stock shareholders.

Common shares come with no special rights.

How Much to Give Up

One of the most common questions startups face is:

How much equity should you give up to the investors?

Below are some guidelines to help answer that question:

Friends & Family Round:

Less than 10%; most often 5-6%

Angel Round:

20-25%

VC Series A Round:

25%-30%

One thing to note is that, it's important to keep the founders motivated. So, if too much equity goes to investors, there's little incentive for the founders to keep going.

As a startup, you want to see value from the investors in addition to funding. Typically, family and friends can only help a little.

Keep in mind, the startup can also use a convertible note which is a debt instrument that converts to equity later. This delays the valuation discussion until the startup has built product, closed customers, and the values in the business are more clearly defined.

Keeping Family and Friends Informed

After funding, you'll need to keep your family and friends investors informed on the status of the startup.

When it comes to keeping these people in the loop, consider the following:

1. Be transparent about the results.

Share both bad news and good news.

2. Stick to facts about the current state of the business.

Don't rely on just forecasts and plans.

3. Provide an update in writing with the following:

- **Lead off with short status updates about:**
  - major initiatives
  - milestones missed or hit
  - major customers or partnership opportunities

- **Share the status of product development including:**
  - test results
  - beta tests
  - Setbacks
  - Breakthroughs

- **Cover the key financial metrics including:**
  - actual versus forecasted revenues

- cash on hand
- current burn rate
- monthly and year-to-date revenues

- **If additional fundraising rounds are underway, provide the status of fundraising goals.**

- **Share details about:**
  - new employees
  - finding a great co-founder
  - securing an experienced advisor

- **Further details to include are:**
  - key customers landed
  - important opportunities
  - major marketing initiatives

PART II: Other Funding Sources

The Purpose of Other Funding Sources

Equity funding is just one source of funding for your startup. In fact, there are many others to consider looking into.

Typically, equity funding is for launching and growing a business. It is also the most expensive form of funding available.

When looking at other sources, it's important to understand that each source of funding brings specific support to the business and can reduce the amount of funding taken through equity.

In reviewing your fundraise plan consider how some of the following may fit in:

- **Grants**

These usually consist of government-based grants that are one-time offerings and need not be paid back.

- **Loans**

This is a type of debt funding which must be repaid.

- **Factoring/AR Funding**

This involves selling your invoices and accounts receivable in return for cash.

- **Equipment Leasing**

Leasing equipment instead of buying it reduces cash burn and spreads out the payments over time.

- **Line of credit**

This is short term debt used for smoothing out the cash flow cycles.

- **Crowdfunding**

Crowdfunding is a funding source that involves prepayment for products.

- **Accelerators and incubators**

These are mentorship programs which provide grant funding.

- **Bootstrapping**

This entails keeping costs low and using revenue to fund the business.

- **Barter**

A barter system for funding works by exchanging services with another company instead of paying cash.

- **Anchor clients**

This is a client who pays for a custom version of your product.

- **Consultation funding**

This type of funding extends your product to include consultation services.

- **Supplier funding**

Supplier funding is contract manufacturing or software developers who provide upfront cash injections in return for a contract to build or design your product.

Grants

Grants are a popular choice for startup funding. They are typically provided by government organizations in order to spur research and make a small contribution to the business. One of the best ways to find these grants is by searching:

grants.gov

Commonly used grants include:

SBIR

SBIR stands for Small Business Innovation Research. An SBIR provides phase 1, 2, and 3 grants that add up to $1m.

Grant funding is usually a one-time offering and need not be paid back.

They are also non-dilutive, which means they don't take any space on the cap table.

When seeking grants for funding, it's important to understand how to use them correctly. As a rule of thumb:

Use grants to cover costs that customers will not.

For example, customers will not pay for basic research but they will pay for finished products.

Keep in mind that grants often come with rules on how they can be spent. Also, be careful in spending too much time with grants. A team may get stuck and become experts at writing grant proposals and fail to service the customer because the team has been focused on writing and winning government grants rather than building a business.

Loans

Loans are a funding source that many startups turn to when launching their business.

Simply put, loans are debt instruments that must be repaid.

One thing that is important to keep in mind when seeking this type of funding is that startups can find it difficult to get a traditional loan from a bank.

However, the Small Business Administration offers several loan types for early stage companies and should be one of the first areas to explore for funding.

These particular loans come with personal guarantees and cannot be closed out with the dissolution of the business.

Additionally, there’s also debt through the use of credit cards and microloans. Just be sure to keep in mind that it is difficult to use debt to pay for your core product development.

Generally, debt only makes sense when you have some revenue coming in to pay for the loan.

There are other types of debt that can be taken into consideration, such as:

1. Accounts receivable factoring, in which you raise money on what customers owe you.
2. Equipment financing, in which the equipment collateralizes the debt.

Factoring works when you have paying customers and want to shrink the cash float from the time you build the product until the time you receive payment.

Equipment financing works well if you need machinery to build your product or run your business.

Line of Credit

Understanding a Line of Credit

Many startups look to a line of credit for their funding needs. A Line of credit is a short term loan from the bank to help smooth out cash flow cycles.

Unlike a bank loan, in which you receive an injection of funds, a line of credit lets you draw upon it when you need it and pay it back when you can.

A few benefits to a line of credit are:

1. The interest rate on a line of credit is substantially lower than credit cards.
2. They offer a higher borrowing limit than most credit cards.

However, the interest rates are often variable and not fixed, so it is very important to pay attention to the rates.

Types of Credit

- **Secured Line of Credit**

A secured line of credit is backed by an asset while an unsecured line of credit is not.

- **Unsecured Line of Credit**

An unsecured line of credit will come with a higher interest rate.

- **Personal Line of Credit**

A personal line of credit is often secured by personal property.

- **Business Line of Credit**

For a business line of credit, the bank determines your credit limit based on the business assets and cash flow.

The bank determines the interest rate by adding the interest to a margin which is affected by your credit history, profitability and business risk.

Overall, a line of credit is a useful tool for early stage businesses to help with cash flow issues.

Factoring

Factoring tends to be a good source of funding for those who are not looking to take on debt. This source of funding entails selling your accounts receivables to a finance company at a discounted rate.

It's not a loan, so you are not taking on debt but rather selling your invoices for cash, albeit at a discount.

How Factoring Works

A typical factoring arrangement gives the business **85%** of the value of the invoices and keeps **15%**.

The factoring company often charges a processing fee and a fee for however many days it takes the customer to pay the invoice.

These two costs add up to be the discount the business is paying for the receipt of cash.

Factoring works well for the company as it comes with long payment terms.

Why Factoring should be Considered

Businesses with a cash flow shortage often use factoring because it is a fast way to access capital without taking on debt.

The factoring company will look at the credit history of the customer paying the invoice rather than the startup providing the product.

However, the cost is giving up a portion of the profits which makes fast cash expensive.

Keep in mind, your customers will know you are factoring as the invoice will be retitled into the name of the factoring company.

Slow paying customers will become more expensive as the cost of collecting their payment will take longer.

Factoring works best for short-term cash flow management when you have predictable payments from customers that take some time.

Equipment Leasing

Equipment leasing is used by startups to reduce cash requirements for the business by leasing the equipment rather than buying it outright.

An equipment leasing company owns the equipment and uses it as collateral for buying the equipment and charges the startup a monthly rental fee.

Types of Leases

Generally, there are two types of leases to consider:

1. **Finance Lease**

This is also called the Capital Lease. A Finance Lease is a long term arrangement in which the startup is required to pay the lease until the end of the contract. The end of the contract is usually the life of the asset.

2. **Operating Lease**

An Operating Lease is for a shorter period of time and is often cancelable.

About Leasing

1. Providers of equipment leasing must have a license and cannot hold or offer real estate.
2. The lease period cannot be fixed for less than three years except for IT and computer equipment.
3. Leased equipment appears as an expense on the income statement rather than on the balance sheet which will reduce the startups liquidity.
4. Long term, the cost of the asset will be higher than that of an outright purchase.

Generally, it’s best to look for a closed-end lease without a balloon payment at the end.

An open-end lease requires you to pay the difference between the value of the equipment and what you’ve paid for it so far.

Equipment leasing usually works best for cash flow management when you have a long-term need for the equipment.

Crowdfunding

Crowdfunding is a method of raising capital through family, friends, customers, and individual investors. It works with a collective effort from a pool of individuals.

There are several forms of crowdfunding such as:

- crowdfunding with prepayment
- crowdfunding from non-accredited investors
- crowdfunding from accredited investors

Crowdfunding Prepayment

Crowdfunding prepayment lets you pre-sell your product before you build it.

This type of funding works best for physical products that require funding for the design and manufacturing of the product.

Additionally, it's a smart way to test the market for a new product. Crowdfunding prepayment provides customer feedback on the product, price, and promotion.

There are several platforms available for showcasing your product, so consider this method if you're looking to fund design, etc..

Crowdfunding from Non-accredited Investors

On these platforms anyone can invest in your startup. It is for equity so you need to understand the implications of it on your cap table.

Crowdfunding from Accredited Investors

This method of funding is no different than raising funding through angel investors and venture capitalists. The only difference here is that you use a crowdfunding platform to find and engage your investors.

There are a growing number of crowdfunding portals offering both general and specialized sites and more and more people are using this as a source for funding.

Crowdfunding works well for startups with a product that is clear to grasp and easy to understand. So, if this sounds like a fit for your business, it’s worth looking into as a key funding source.

Bootstrapping and Bartering

Bootstrapping

Bootstrapping works by using your own funds in addition to the funds of your initial customers to launch your business.

One of the things that is most attractive about bootstrapping is that investors find it a great way to test how serious you are about your business in addition to how much work you are willing to put in.

Another reason bootstrapping makes sense is because if you are able to find prospective customers who will prepay, then it demonstrates market validation.

Bootstrapping your startup is also a great way to stay disciplined with your cash flow. When you spend your own money you'll find you spend less of it.

Bartering

One of the main reasons to consider bartering is because it is a useful tool to reduce cash expenditures.

Consider providing your services to businesses who can provide you something you need in return for services such as:

- bookkeeping
- accounting
- legal work
- financial work

Being able to barter successfully is attractive to investors. It's a good skill to have because it demonstrates resourcefulness and the ability to negotiate.

Overall, bootstrapping and bartering build skills that will help you throughout the life of your business as you'll start with a lower cost basis, spend more carefully, and negotiate better throughout the course of your business.

Anchor Clients

Anchor clients are important because this typically means that you have a long-term and ongoing relationship with a potential source of funding income. Anchor clients are those who prepay for a custom version of your product. These types of clients are often larger companies who have special needs.

If you are building an enterprise or consumer software product, consider looking for an anchor client to pay you to build a custom version of it if you are looking for funding.

Here are a few benefits of having Anchor clients:

1. Anchor clients can provide funding.
2. These types of clients usually have clear specifications of what they want.

A lot of times, anchor clients are in a rush to find a solution. This can be great news for your business because it means they will pay the best price for the product.

Another key benefit to having anchor clients is their ability to give you insight into the market. They can offer up a lot of key information about a particular market because they have researched it and not yet found a solution to meet their needs.

Anchor clients also make great references when you launch your standard product into the market. They can attest to your quality and expertise.

In order to fully fund a first version of your platform, you may be required to take on more than one anchor client. To do this:

- Take the funding you need to build your platform
- Divide it by 3
- look for 3 anchor clients to cover the cost

Consultation Funding

Consultation funding is using consultation work to help fund your business and pay salaries while you are building out your product.

Many customers need additional help and will pay consulting fees for it on top of the basic product.

Consider looking for consultation work in addition to selling your product. Do not underestimate customers wanting extra assistance in areas such as installing and using the product. Many times, customers will be interested in this type of assistance in addition to the product itself.

Consultation also:

1. Brings new insight into how the customer intends to use the product.
2. Can highlight what problems your customers are trying to solve.

This is useful information to guide your product roadmap and allows you to tailor the product even further to the customer’s needs.

Consulting work also gives you more information about the market and the competition when it comes to encountering competitive solutions.

While consulting may not be your ultimate goal, it can be a useful way to fund a portion of your product development while simultaneously allowing further insight into your customer base.

Accelerators and Incubators

Accelerators and incubators provide startups with:

1. workspace
2. mentorship
3. pitch practice
4. funding

They are typically sponsored by:

- universities
- companies
- entrepreneur collectives

Accelerators

Accelerators offer a variety of support services and funding opportunities for startups. They provide an intensive program to help the entrepreneur prepare their business and product for an initial investment.

The classes are usually small and consist of 5 to 10 companies at most.

Programs span the course of a few months and by the end, the participants pitch to investors for funding.

Incubators

Incubators are often focused on the growth and success of startup and early stage companies. They offer:

- a physical workplace with offices
- administration
- meeting rooms

Understanding Accelerators and Incubators

1. Universities offer accelerators and incubators for students and faculty who want to commercialize research.
2. The accelerator or incubator may have a fund from which it invests in startups that complete the initial program. This often takes the form of equity funding but some programs structure it as a grant. They often sponsor demo days in which you pitch to prospective investors.

Contractor Funding

Many enterprise software programs come from service businesses solving a problem for their clients.

In searching for a solution in the market, they find none.

So, they build their own.

Later, other clients are attracted to the solution and come ready to buy it as customers.

This is called **contractor funding**.

It's one of the most overlooked forms of funding in the startup space.

In this method, you sell a customized version of what you want to build to an anchor customer for a substantial one-time fee, for example: $250K.

You then use the funds to build out the platform you envision of which the customer gets a non-exclusive license.

The advantage is you have a customer telling you exactly what they need and what they will pay for.

The biggest benefits you gain are:

1. They improve the product by testing it and telling you what changes to make.
2. They become a satisfied customer which you can use to attract other prospective customers.

After 3 more of these engagements you will have $1M of investment in your platform with zero dilution. For your raise, consider using contractor funding as an untapped source of cash.

About TEN Capital

TEN Capital Network provides funding as a service to companies anywhere raising venture capital. Its network of over 11000 accredited investors represents venture capital, angels, family offices, and high networth individuals.

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