Capital funding and the fund raising basics

By Evan-Lee Courie

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Startup and entrepreneurs across the world are back at their drawing boards as they navigate towards a post-Covid world. There are still many who are curious as to what is needed to start a business and how to go about it. In the coming weeks, successful entrepreneurs and experts will unpack some basics of funding, what you need to know and what opportunities are on the horizon

Antonia Bothner, Endeavor South Africa Capital Markets Lead and Fundraising Lead at Endeavor Harvest Fund, uncovers the basics of capital funding and provides suggestions on how to access it...

What is capital funding?

Capital funding by definition is the investment or cash contribution that helps a business get started and grow. It’s like the sunlight, water, air and soil that enables the seed to grow into a sapling and eventually a tree.

Capital funding can be in the form of debt, equity, grants or a hybrid of all three.

- **Equity funding** allows for ownership by the investor and the potential of growth (and dividends) as well as the shared risk that that brings - you can think of it similar to a marriage.

- **Debt funding** requires a repayment of the capital + interest, there is no ownership and risk is often lower thus it is generally cheaper but needs a business to have stable cash flow. (Although there are different types of debt, such as venture debt for growth stage businesses where the lender takes comfort in the future prospects of the businesses and its funders).

- **A grant** will not need to be repaid but often requires some form of impact or developmental return that is measurable.

> *The most suitable capital funding will depend on a myriad of factors, including, where in the growth cycle a company is, the business model of the company and the risk appetite of both parties.*

Some markets are more sophisticated than others and often complex legal agreements are needed to put these structures in place.

How does one get access to capital funding?

Funding can come from multiple avenues.

> *Equity funding often starts with personal savings, family and friends, and crowd-funding.*

It then moves onto more formalised angel investors, venture capital, followed by growth equity and private equity for bigger quantums and finally via a mergers and acquisition or an initial public offering (IPO) in the public equity markets or stock exchanges. Again, the type of funders will very much depend on the nature of the businesses.

A "mom-and-pop" store might be able to access funding from friends and family, or maybe even its bank if it has stable cash flows and security; but a venture capital fund would only only be interested in a very high growth business that has the potential to scale exponentially, often across geographies. This is the space that Endeavor plays, backing high-impact entrepreneurs that are growing their business rapidly.

> *Debt funding will come from family and friends initially as well as micro-financing and small loans from banks as well as venture debt funds, private equity firms on debt, development finance institutions (like the IDC, Norsad or the IFC), and then public markets ie the bond market.*

> *Grant funding tends to come from philanthropic family offices, NGOs, Endowments, Governments, DFIs and Impact Funds which may offer a combination of both grant equity and debt.*

- ***There are two primary routes a business can take to access funding: raising capital through stock issuance and raising capital through debt. Could you briefly elaborate on these options?***

Debt is often more suited to a company that has assets it can secure against the debt (a bank will often ask for collateral) or in a company that has a stable cash flows.

A company that is at an early stage and growing quickly may find it hard to pay back debt in the early stages of growth as cash is reinvested back into the business rather than debt holders - think of this stage like feeding a growing child.

Equity is more suited in this instance as it enables the investor to share the risk of this growth instead of prioritising cash flows too early which can hamper growth and value. Often at the early stages of growth, hybrid debt-equity instruments are used, rather than pure equity. These include SAFES and Convertible Notes.

Although debt allows for less equity dilution of a founder, the dilution in equity and control should be compensated by the value of having a strategic equity investor on board to share the risk in growing the business.

The value is in having a small slice of something big and shared (which is ultimately what a stock is) rather than a big slice of something small. Historically innovative ideas need large amounts of patient capital to reach their potential, for instance imagine if Apple hadn't had patient enough investors to back them?

Are there any drawbacks to sourcing capital through these routes?
There will always be a tradeoff. In debt and equity, the main tradeoff is between control and growth. With debt, one does not give up equity/control but there is a requirement to pay back the capital plus interest in a certain timeframe.

With equity, the tradeoff for dilution in shareholding and control is funding and/or strategic partners for growth. This type of funding is best suited for high growth startups whereby the growth offsets the loss of dilution and control.

Where would a first-time business owner start?
A first-time business owner should first understand the needs of the business and then work out the best source of funding - not the other way around. Speak to people and mentors already in this sector. It is critical to work with capital providers you trust. This is a long-term partnership – building your business will have ups and downs, and you want a patient, supportive partner to back you when the going gets tough.

As a rule of thumb, debt will always be cheaper but not necessarily in a high growth, asset light businesses.

> “ *It is always best to start with immediate stakeholders who understand the businesses and its vision/potential - this means an easier conversation when it comes to pricing for risk.* ”

Let potential funders get to know and trust you, people invest in what they know and trust.

Engaging customers and suppliers are often a great source of capital. Crowdfunding is also a popular source as well as bank loans, grants. Be specific and niche in terms of the capital pools identified. There are also a host of accelerators which give a route to funding and offer soft capital and support. Grant funding is also abundant especially in the impact space.

Are there any specific criteria to access capital funding?
Depending on the stage and quantum of funding, capital providers will want some level of comfort around money they invest and they are often in fiduciary positions.

> “ *Accountability, reputation and trust are key.* ”

Each funder will have a specific mandate with subsequent criteria attached, it is important to get to know what these are. As a rule of thumb, a capital provider will want to be able to assess the risks and return so criteria which give comfort around this is key. Track record, pre or post revenue status, team dynamics, competition, traction, cash flow are all factors that will come into play.

There is a debate in venture capital circles whether one backs the jockey or horse. The reality is that businesses are all about people. People invest in people, ultimately.

What is something that someone starting a business needs to know, but doesn't?
The success rate of startups is very low. Be very clear about why you are starting a business.

> “ *Success requires 100% commitment and passion to an extent of crazy, it is not going to be easy - one needs more than a good idea to succeed.* ”

Networks are everything, especially ones you can trust. Always be open to listen to what the person next to you, or a mentor has to say and offer - the ability to listen and pay attention are your best resources.

What happens after capital funding is secured?
If funding has been obtained correctly there should be a plan and strategy with how the funds are to be used. Making sure that the money is invested in an efficient way and communicating this to investors is key to ensuring the relationship is nurtured. Capital efficiency is absolutely critical.

Return on equity is the most important metric a founder needs to know and this is what an equity investor will most likely focus on. Communication is important, funding comes with responsibility and your stakeholders need to be managed accordingly as they will be your supporters in times of need and opportunity.

What is the best advice you can give to anyone starting a business?
Find your passion and follow that, build a network and tell people about your ideas. People want to help, if they don't know how to, they can't.

> *Be clear about what your ask is, the clearer you are the easier it is for people to help.*

Develop humility quickly, being able to iterate and fail fast forward is critical, in businesses and life nothing is personal, everything is just feedback. It is important to separate a business from personal life even if the two can seem inextricably intertwined.

Work with great partners and focus on building the right team. Building a business is a marathon (even if it can feel like a sprint!), building resilience and a strong foundations are going to stand you in good stead.

Do you see any trends in the funding of startups?
There has been an increase in funding flowing to startups with accelerators and angel investors. Liquidity is finding its way to the entrepreneurial communities especially if one looks at dual focus funds of both impact and profit.

Grant funding with an ESG focus is abundant. The drawback is often that it is one off whereas most businesses need continuous support.

> *Funding is also starting to come from successful entrepreneurs reinvesting back into the ecosystem.*

In South Africa, there has traditionally been a gap at growth stage funding rounds (Series B+), so start your fundraising journey early and work with ecosystem partners like Endeavor if you intend to dominate your market or scale globally.

Endeavor is a global high-impact entrepreneurship movement to drive long-term economic growth and build strong entrepreneurship ecosystems in South Africa by selecting, mentoring, and accelerating the best high-impact entrepreneurs.

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