

SOURCES OF CAPITAL FOR START-UPS

**DR DAVID MILLHOUSE
HONORARY ADJUNCT SENIOR RESEARCH FELLOW
FACULTY OF LAW
BOND UNIVERSITY**

Introduction

Raising capital is a long hard process requiring considerable time, patience and shoe leather. Many start-ups underestimate the time and financial resources required to achieve a result. Many also do not comprehend that capital raising activities are rarely one-off activities. Rather it is a constant process of raising capital from different sources, in different locations for different applications of funds, and importantly, at different prices. This is called 'Capitalisation Planning'. It is a director level responsibility. That responsibility includes the planning of liquidity events ('exits') for earlier investors and in some cases an Initial Public Offer ('IPO') or Compliance Listing on a recognised securities market. The task of attracting investors into start-ups becomes considerably easier and quicker if the capitalisation planning is thoroughly undertaken and well presented.

Ventures that succeed are not generally solo one-idea or one-product enterprises. Successful ventures are those with a functioning cohesive management team experienced in building listable public companies. Indeed, misunderstanding this paradigm has led to disappointment and claims of capital market failure. It also leads to misunderstanding of where to source start-up capital. Australian start-ups should think globally, at least investigating comparative jurisdictions. Often, their product and services markets will be in those jurisdictions and capital easier to raise accordingly. It is poor strategy though to seek offshore capital without a business plan to justify it. This is a credibility issue and can quickly lead to assumptions of malfeasance or poor reputation. Not all of this is deserved, but will occur. Just as corporate structure needs to follow strategy, so does the capitalisation plan. Similarly, many Australian investors are reticent to invest in offshore structures. They will need a sound strategy and a credible, experienced, and trustworthy management team.

Corporate Advisors

Commonly, directors appoint corporate advisers to assist and in some cases to undertake capital raising. Corporate advisory and investment banking firms come in all shapes and sizes. All come with fee structures. Most are structured with a retainer and a performance fee often paid in preferential equity. Some investors will not negotiate with start-ups which have appointed advisers, particularly those with a performance fee, whether it be in cash or equity. Many advisers are reputable and provide value adding corporate services in consideration of their retainer. Some are not. Very few are themselves investors. Some investors require a precursor advisory contract, in effect a fee for due diligence. Fee structures vary enormously between jurisdictions and the likely source and species of capital to be raised. Debt raises are normally priced differently to equity raises.

The darkened canyons of central cities are replete with advisers, each with their fishing rods hoping to catch the next sweet start-up fish naively assuming that all advisers behave in their company's best interest. They do not, and in Australia, even if there is a fiduciary relationship between the adviser and client, *Citigroup*¹ demonstrates it is possible to contract out of it. The advisory relationship will normally be governed by contract. A start-up director should spend time on the negotiation of this contract. Agency principles may also apply. If possible, include a fiduciary provision. Typically, these contracts operate for a

¹ *Australian Securities and Investments Commission v Citigroup Global Markets Limited (ACN 113 114 832)(No 4)* [2007] FCA 963.

lengthy period and contain non-circumvention and future benefit provisions which can easily be forgotten by the management of the start-up.

It is rare indeed for any one corporate adviser to have all of the skills sets and capital markets reach needed by the start-up in its capitalisation journey. Contracts should be very specific and limited to the skills and reach of the adviser with express provision for the appointment of others as required. This principle should apply to other professional advisers. Legal skills needs are wide ranging and not limited to corporate law, or indeed a single jurisdiction. Legal skills in intellectual property, capital and international taxation, knowledge of valuation and accounting principles by lawyers responsible for drafting are generally required from start-up date. The consequences of not having these skills manifest later and often in financially undesirable ways. It is not unknown for a shareholder agreement to contain multiple, conflicting or no definitions of basic accounting and valuation terminology. Similarly with accounting skills sets. It is unlikely these required skills sets will be found in a single adviser or a single firm.

Not all corporate advisers are required to hold an AFSL. They must if their business is to provide financial advice or a financial product.² Definitions of financial advice and financial products are set out in the *ASIC Act*³ and the *Corporations Act*.⁴ They are important definitions for start-ups especially in the event of later claims of misleading and/or deceptive conduct. Firms claiming to be investment banks or merchant banks must be licenced. Similarly, professional advisers in the law and accounting professions must hold relevant accreditations. Corporate advisers dealing only in wholesale capital markets may not necessarily hold an AFSL, but lack thereof circumscribes their activities. That is not suggesting they cannot add value in specific ways. To provide an exempt service the adviser can advise on the 'acquisition or disposal, due diligence, establishment, or valuation of an incorporated or unincorporated entity, if ...'⁵ This advice is only for the use of directors and senior management and cannot be used in an offer document, even for an exempt offer. Where directors rely on advice in the absence of an AFSL, it is their responsibility to ensure compliance in its application.⁶

Public v private

The public v private choice is an extremely important board decision. Commonly in Australia, start-ups seek an IPO very early in their life cycle. This is atypical but not unknown in comparative jurisdictions where private capital of various forms is more prevalent. Some advisers will promote the IPO route. It is not glamorous. It is extremely costly, and fraught with aftermarket share price risk. The public securities markets in Australia include the Australian Securities Exchange ('ASX')⁷ and the Australian Small Scale Offerings Board ('ASSOB').⁸

Public securities markets in comparative jurisdictions

Directors should consider it a normative condition to research and use capital markets in other comparative jurisdictions if the business plan justifies it. Public securities markets for start-ups exist in the United Kingdom, Germany, Denmark, Sweden, Canada, United States, Singapore, and Hong Kong, being the most comparative jurisdictions. The United Kingdom markets have a volatile history with the closure of GXG, and the evolution of Alternative Investment Market ('AIM')⁹ the small scale market for growth companies of the London Stock Exchange ('LSE').¹⁰ Similarly, GXG was closed in Germany and Denmark. Germany has at least 15 public securities markets, being (as in Australia pre-ASX) Federal State (Länder) based. A quotation of securities on one of the Stated based exchanged (eg Stuttgart, Hamburg, Berlin) may result on a compliance based quotation on another of those exchanges. The major securities exchange by a

² *Corporations Act 2001* (Cth) ss 911, 913.

³ *Australian Securities and Investments Commission Act 2001* (Cth) ss 12BAB, 12DA(1).

⁴ *Corporations Act 2001* (Cth) div 3, 4, pt 7.1 ss 766A, B.

⁵ *Corporations Regulations 2001* (Cth) reg 7.1.29 (3)(c).

⁶ See also, *Validus Advisory Group Pty Ltd v Consolidated Tin Mines Ltd* [2018] NSWSC 417.

⁷ <www.asx.com.au/>.

⁸ <<https://assob.com.au/>>.

⁹ <www.londonstockexchange.com/aim>.

¹⁰ <www.londonstockexchange.com/>.

large margin is the Frankfurt Stock Exchange ('FSE')¹¹ which is owned by the Deutsche Börse. FSE historically has a number of different securities markets for companies at different stages of their life cycle, and differing market indices for differing types of companies, known as 'issuers'. The two senior FSE markets are known as Prime Standard and General Standard, both subject to government supervision as well as exchange supervision. A quotation on a German market may also result in a compliance listing on a smaller United States market. Well known US markets are the New York Stock Exchange ('NYSE'),¹² NASDAQ,¹³ and Over the Counter ('OTC')¹⁴ markets including Bulletin Boards. NASDAQ has a European offshoot – NASDAQ North¹⁵, of interest to the start-up sector. Canada has the Toronto Stock Exchange ('TSX')¹⁶ and the TSX Venture Exchange¹⁷ based in Calgary for small companies. There are also provincial securities markets. Singapore¹⁸ and Hong Kong¹⁹ both have senior securities markets.

Notably, there is considerable volatility in the structure of these markets and their listing rules. All have fee structures, and all have accredited advisers effectively controlling access to those markets. Some are auction based (eg ASX), some operate using market makers (NASDAQ North, FSE junior markets).

Once the directors have clearly defined long term corporate strategy, then the relevance of one or more of these public markets becomes evident. What they can all do, in their various ways, is to facilitate liquidity events and exits for earlier, usually private investors.

Types of private capital

There is no one source of capital. There are different typologies applied to similar forms of capital. Private investment can be categorised as: angel investors; matching services; venture capital funds, private equity funds, development capital funds; SMSF; family office and trust funds; investor clubs; corporate venture capital; corporate strategic investment; structured finance; managed investment schemes; financial planning and wealth management firms; retail superannuation funds; industry superannuation funds. All of these sources are dispersed geographically, by their nature private, and often difficult to access. Some are in established industry structures with published investment criteria.^{20,21} As in public securities markets, access can be improved by the appointment of skilled corporate advisers. Whatever the source of the capital, it is essential to be knowledgeable of its provenance.

Government agencies can also be a source of capital. Some of this capital is on a matching grant basis, being the norm in Australia, but other jurisdictions operate differently. Singapore, as a matter of national economic development strategy invests government funds as equity, including in start-ups. It actively encourages entrepreneurship (and Australian entrepreneurs). These investments are normally through one of its agencies. The Singapore Economic Development Board, Temasek, and Government Investment Corporation each have specific investment criteria.

Angel investment

Angels are not always angelic. They are private investors directly, through their SMSF or family trust that seek a risk adjusted return. Their expectations of high returns from early stage investing can only be met by the creation of liquidity events for them. Some angel investors look for directorships and management positions as a means of earlier capital return. There is a distinction between investing, corporate governance and provision of management services. Directors of start-ups ignore these differences at their peril. Similarly, issuance of securities with preferential rights as an inducement is also fraught with risk and

¹¹ <www.frankfurtstockexchange.de/>.

¹² <<https://www.nyse.com/>>.

¹³ <www.nasdaq.com/>.

¹⁴ <<https://www.otcm Markets.com/>>.

¹⁵ <www.nasdaqomx.com/transactions/markets/firstnorth>.

¹⁶ <<https://www.tsx.com/>>.

¹⁷ <<https://www.tsx.com/trading/tsx-venture-exchange>>.

¹⁸ <<https://www.sgx.com/>>.

¹⁹ <<https://www.hkex.com.hk/>>.

²⁰ Australian Venture Capital and Private Equity Association, <<https://www.avcal.com.au/>>.

²¹ Singapore Venture Capital and Private Equity Association, <<https://www.svca.org.sg/>>.

may deter those later investors required to finance the business plan. Often, those rights are set out in a shareholders' agreement. These contracts can also be problematic for similar reason. The most effective form of angel investment is where the start-up founders identify and recruit new shareholders who share the vision and have agreed to the business and capitalisation plans. A commonality of objective and interest is required.

There is a plethora of formal angel groups operating in Australia, some as exempt matching services, and there are industry associations who seek to represent the angel community. Access to those who are not part of the formal network is through financial planning and wealth management firms whose role is to advise their clients. Some of these angel groups have manifested in 'investor clubs'. All are subject to specific business matching service regulation or, if not, then more broadly in capital raising law.

Venture capital investment

Venture capital is often confused with 'development capital' and private equity. In each of these, capital subscription is typically structured as 'rounds', nowadays using the US notations Series A,B,C etc. These notations reflect the stage of maturity of the business. Series A is post-seed or start-up, typically in the range \$2-5 million; Series B is expansion capital, typically in the range \$2-10 million; Series C is generally sourced from larger funds for market leadership aspirations with a larger quantum of capital. Each of these discrete notations has a meaning to the venture capitalist, if not to their investee. Seed and start-up capital also tends to be used interchangeably. The primary distinction between venture capital and private equity is the cash generating ability of the investee. Private equity is often but not always leveraged (and not always to the benefit of the investee or its earlier shareholders). Venture capital is usually equity or convertible securities. It usually comes as preference equity with features of the security issuance limited only by the imagination and negotiation skills of the investor. These are designed to force liquidity events favoured by the venture capital investor. As in angel investing, understanding the 'game' and having negotiation skills to play it are essential.

There are many venture and private equity firms in Australia.²² It has a well-developed equivalent in Singapore.²³ As with angel investment, these infrastructures exist in all comparable countries. The depth and breadth of these markets is such that capitalisation planning needs to be very focussed to avoid waste of management time. This is an important board level competence. Venture capital firms usually publish their investment criteria. These criteria include stage of investment, industry sector, size and duration of investment, requirement for director and management services appointments, preferred exit routes, and geography. Research to accurately define which of them are suitable potential investors saves considerable time. Those that do not invest this time are often disappointed, it being expressed in market failure contexts. Every comparative jurisdiction operates this way.

In Australia, almost every venture capital firm is a 'closed end' fund, typically operating for ten years. Capital is subscribed or committed at inception with investment and capital drawdowns thereafter. Importantly for start-ups which need some years for growth, maturation and exit, venture funds which are in their later stages of investing may not be appropriate investors. They may not be able to meet the required duration of the investment. Another part of the game. Some are open ended funds, and some closed end funds may be able to extend for a short period. This information will be found in their trust deed poll or constitution. Extensions may require unit holder approval.

Family offices

Australia does not yet have the rich ecosystem of family offices to be found in the US, but it is growing. Family offices are usually structured as trusts and operate as private venture capital and private equity entities for the beneficiaries. Some include superannuation entities. Most have internal professional and corporate advisers who are able to facilitate access to capital. Material investment decisions are usually made by the trustees, often the family members, sometimes operating in corporate rather than private

²² See above n 20.

²³ See above n 21.

form. Their duty is to the beneficiaries and the extent of that duty and its enforcement varies according to form.

Corporate venture capital

Similarly, Australia does not have the tradition of corporate venturing found in Europe or the US. In recent times, there has been considerable Australian corporate activity in FinTech, where the corporate venturers are seeking strategic technological improvements to their core business as well as successful equity investments. This has not extended to the Australian life sciences or medical devices sectors. A German start-up in these sectors has a plethora of corporate venturing opportunities including access to skills and infrastructure within easy travel distance.

Corporate venturing is an important sector of an advanced entrepreneurial economy. It brings more than venture capital. Importantly, it brings human resources, manufacturing expertise, and markets. Essentially for traditional angel and venture investing, it provides exit opportunities. Australian exits have been heavily skewed to IPO. This is not so in comparative jurisdictions where IPO's of start-ups can be rare. This is an underdeveloped venture sector in Australia. There are some corporate venture capital firms who are members of AVCAL but generally market intelligence is required to identify those in the market. It is also volatile as their corporate strategy, directors and senior management change.

Superannuation funds

There are many types of superannuation fund. These include SMSF's, corporate superannuation, retail funds, and industry funds. Almost all superannuation funds are trusts with a corporate trustee supervised through the *SIS Act* and separately regulated by the *Corporations Act*. It is true that Australia has the 4th largest pool of superannuation savings globally, currently some A\$3.2 trillion, and expected to grow to A\$6.0 trillion by 2036.²⁴ It is not true to assume that this capital is to be deployed under political or public pressure for 'economic development' purposes, popular projects of the period, or should have a notional portfolio allocation to venture capital. Indeed, the sole purpose test in the *SIS Act*²⁵ seeks to prohibit such activity and requires investment strategy to be for the financing of retirement incomes.

Further, since superannuation funds are trusts, the trustees are subject to trust law as well as statutory supervision and conduct regulation. Directors of the corporate trustee have personal and direct liability²⁶ to the beneficiaries as well as to the corporate trustee (normally a company). In the superannuation environment, the trustee 'best interest' means 'best financial interest' and directors of the trustee are required to assess market and liquidity risks of their investments and the longevity risks associated with their beneficiaries.

The investment strategy must be in the best financial interests of the beneficiaries. This is normally done by an investment committee, its advisers, and then the directors of the trustee. Those seeking start-up capital must therefore seek to gain a presentation to the investment committee. Selection of which fund to approach depends on the asset allocation strategy and position of the fund. These are not generally published. It is an area where the start-up director should seek advice and guidance from a limited pool of corporate advisers in this sector.

In Australia, there is a tendency in capital markets to emulate US practice, particularly arguments to deploy superannuation into 'alternate assets' including venture capital, private equity and hedge funds on a modern portfolio basis to reduce overall portfolio risk whilst generating alpha returns. Such investment policies ignore the distinctions in Australian law. Each investment decision is discrete, not portfolio based. That it may not result in optimal investment portfolio performance is irrelevant.²⁷ In practice, trustees

²⁴ David G Millhouse, 'A business and legal analysis of the systemic failures in the Australian financial products and financial services sectors: have weaknesses in corporate governance law contributed to this cyclical failure and are there legal solutions?' (PhD thesis, Bond University, 2018).

²⁵ *Superannuation Industry (Supervision) Act 1993* (Cth) s 62.

²⁶ *Superannuation Industry (Supervision) Act 1993* (Cth) ss 52(8), 29VN(a)–(b).

²⁷ P U Ali and M Gold, 'An overview of "Portable Alpha" Strategies, with Practical Guidance for Fiduciaries and some Comments on the Prudent Investor Rule (2001) 10 *Company and Securities Law Journal* 276.

(superannuation and non-superannuation) must undertake a very high standard of due diligence on each investment and not rely on US-inspired funds management models.

Managed Investment Schemes

'MIS' are also trusts. They can be registered or unregistered depending on the number and type of investors. Scheme is not a defined term but a MIS must have three qualifying features.²⁸ An 'interest' in a MIS is a defined term.²⁹ In the general law, 'All that the word "scheme" requires is that there be some programme, or plan of action'.³⁰

Start-ups can establish themselves as a MIS instead of a company — investor preference usually determines that choice. Some investors, particularly non-Australian residents and SMSF's favour the trust structure. MIS issue units and registered MIS are required to issue a Product Disclosure Statement ('PDS') which is lodged with the ASIC. Registered and unregistered MIS are regulated differently by the *Corporations Act*³¹ Unregistered MIS are not required to issue a PDS but do require a different form of offer document, usually an Information Memorandum. Unregistered MIS are still subject to the capital raising provisions of s 708.

Presently, there are relatively few new MIS in Australia and almost none seeking new investment opportunities. There are historical reasons for this position,³² but that does not alter the usefulness of the trust structure for start-up investment and their likely attractiveness for future start-up investments, particularly for SMSF's. There is presently a dearth of MIS investment opportunities. This may indicate pent up investor demand which could be filled by start-ups as a new generation of MIS.

Structured finance

The capitalisation planning journey always needs to plan for scale. It is scale and market share which are the strategic underpinnings of liquidity events and exits. Scale may involve the acquisition of factories and other commercial properties. It may involve mergers and acquisitions including in other jurisdictions. These require finance, generally understood to be structured finance arranged by investment banks. To directors of a start-up, these may seem lofty ambitions. To an investor, they provide confidence that there is an end-game in which they can participate. Market leadership generally implies superior share pricing and structured finance is a specific source of funding to achieve that result.

Conclusion: understand the game

If you were to sail solo around the world, would you learn to sail and acquire navigation skills? Would you surround yourself with an experienced support team? Such a voyage is not for the faint-hearted. Those that achieve it are public heroes. So too with building start-ups. It requires skills, patience, and intestinal fortitude. It is not a one person game; it is a team effort with no room for out of tune players in its orchestra. The analogy is not quite complete: start-up entrepreneurs usually do not become public heroes, at least in Australia. This is where your investors can assist greatly provided there is a match between your expectations and theirs.

For a more detailed explanation see David Milhouse, *Corporate Governance in Non-Bank Financial Entities* (LexisNexis Butterworths, 2019) 228 [5.47]–[5.49].

²⁸ *Corporations Act 2001* (Cth) s 9.

²⁹ *Ibid.*

³⁰ *ASIC v Chase Capital Management Pty Ltd* [2001] WASC 27. See also, David Milhouse, *Corporate Governance in Non-Bank Financial Entities* (LexisNexis Butterworths, 2019) 181 [3.113].

³¹ *Corporations Act 2001* (Cth) pt 5C.

³² David G Millhouse, 'A business and legal analysis of the systemic failures in the Australian financial products and financial services sectors: have weaknesses in corporate governance law contributed to this cyclical failure and are there legal solutions?' (PhD thesis, Bond University, 2018).

