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A FOUNDER'S GUIDE TO RAISING EQUITY

Steps to Take to Fund Your SaaS Business

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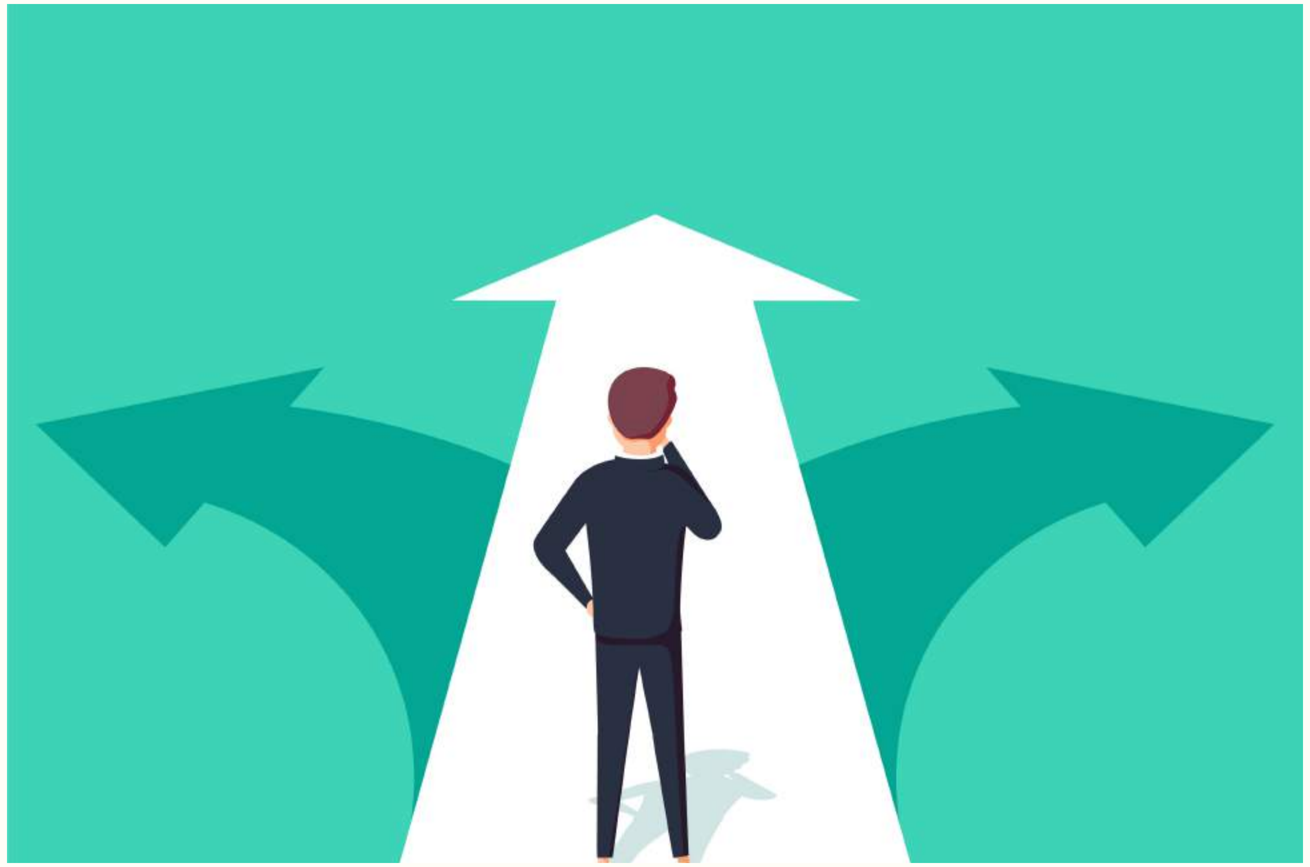
Steps to Take to Fund Your SaaS Business

Raising funding for a company has always been a challenge for founders. Here we layout out different aspects that Founders need to consider to help navigate the process and minimize dilution and retain as much of their ownership stake as possible.



Key Inclusions:

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SaaS Finance Today

There are thousands of passionate SaaS founders working in many different ways to grow their idea, product, or solution and have ambitious goals for the future of their businesses.

However, many founders struggle to understand the finance options that allow them to minimize dilution and retain as much of their ownership stake as possible.

Finding the right finance at the right time is an important piece of the founder jigsaw and in a world where inflation is increasingly an issue, the cost and availability of money is the notable outlier (this is changing as interest rates rise). We know from history that cheap money leads to massive market distortions, and today is no different. Just as equities have become disconnected from fundamentals, so too have funding and credit markets.

Growing businesses need finance/funding to fuel their business, and many SaaS/tech founders often see an equity raise as validation of their business growth. However, we look at things a little differently!

Equity can be an excellent option for founders. However, the timing and terms on which equity is raised are crucial. Of course, there are now many different options available mood Morning.

When is Equity Right for a Business?

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01 When a high cash burn is needed to achieve growth

Equity funding is usually required when a business must burn a lot of cash to develop a product or reach critical mass in its customer base. Therefore, this additional risk taken by equity investors is rewarded in spades if the company is successful. Lenders, by contrast, are effectively capped on how much capital they can provide a company due to their capped returns. In simple terms, the maximum a lender can make is the agreed-upon interest rate.

A helpful way of looking at how much cash a company is bleeding the ratio of recurring revenue to net cash burn. This can be calculated as monthly net cash burn divided by MRR. The lower the ratio, the safer it is to lend you money. Plus, the money lent won’t be burned too quickly as you continue your growth path. But for SaaS companies burning cash rapidly, debt alone won't provide enough fuel to get them to where they want to be. Equity is, therefore, something to consider.

When raising equity, make sure you have a robust forecast for the amount of capital you need over the coming year or two. Best to err on caution and ask for a little more than you require. Raising equity takes a lot of time and effort, and you don't know the exact time the next funding round will close.

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02 The customer acquisition payback period is long

Companies have to invest cash to grow. But waiting to recoup customer acquisition costs doesn't allow you to reinvest profits for growth soon enough. This tends to argue against using debt finance, as your cash flow may not yet be sufficient to meet interest and principal obligations.

Long story short, if your customer acquisition payback period is lengthy, longer-term capital may be better.

Sometimes, companies use a mix of equity and debt in this scenario.

03 The business is pre-revenue or expects low revenue for a while

Re-revenue companies have no choice but to raise equity from angels, friends, family, or the founders. Equity investors buy into ideas and the people driving those ideas. Debt providers won't lend to a business with no revenue on which to secure their investment or with which you can fund repayments.

Most SaaS lenders will provide you with a multiple of your recurring revenue. However, if your growth plan involves you being zero or low on revenue for a while, you'll need to look for equity.

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04 Only predatory loans are available

In addition to higher interest rates, predatory lenders may require board seats, large equity warrants, extortionary prepayment penalties, personal guarantees, or outrageous covenants.
If this is all that is available to you, you might be better looking for equity instead.

This type of predatory financing may put your company at risk, and you don't want to lose control of your company by trying to save equity. Watch out!

It would be better to find an equity partner who can see your vision and support your growth until more reputable lenders are willing to work with you.

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05 You are considering a bolt-on acquisition

If you are in the market for a SaaS bolt-on acquisition, you will probably pay between 1x and 10x of that company's annual recurring revenue (ARR), depending on its growth, business sector, etc., that number might change.

Debt providers finance mergers all the time, as long as it makes sense in terms of synergies, product cross-sells opportunities, or product-market fit.

Some lenders will include the bolt-on company's MRR (monthly recurring revenue) in the calculation to determine your creditworthiness. However, you'll still be limited to around 3x-10x of the combined MRR of both companies.

Therefore, venture debt providers will be able to help you fund a bolt-on if the math works out to cover the purchase price. If a more extensive or more expensive acquisition is on the table, debt can get you part of the way, but you'll need an equity partner or cash in the bank to fund the rest.

If you believe that equity is a good fit for your company's future, it's time to get ready for the raise.

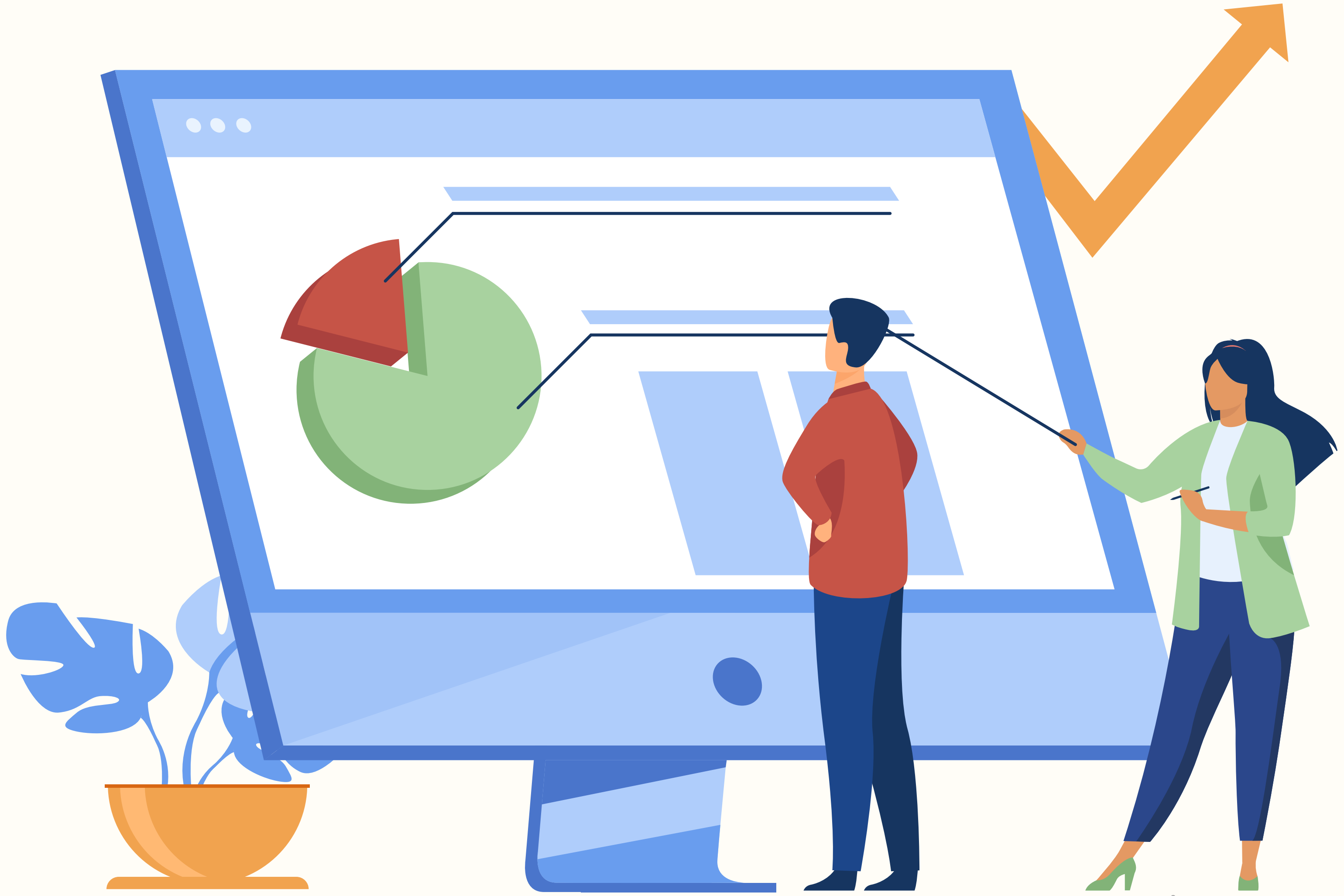
Preparing for the Raise

If you are a founder who has never raised money from outside investors, it may seem like something that can be done quickly and without much planning. The reality? Equity raises are incredibly time-consuming (they can take 6-9 months), require detailed preparation, and can take the focus off running the day-to-day business.

By following a roadmap, founders can give themselves the best chance at closing the deal. Before a company starts raising money, they need to get its ducks in a row.

When raising debt, lenders will request different items through the evaluation and approval process. In addition, some lenders offer a technology platform that allows you to share financials to help streamline the process.

We've gathered a checklist to help you prepare for funding applications and ensure you've included information investors may need to decide to fund your growth. This list is not exhaustive but consists of the core items for founders and management teams to gather to ensure a smooth process.



Financials

- Two Years of Historical financials (P&L, Balance Sheet, Cashflow)
- Forecast Financial Model (12-24 months: P&L, Balance Sheet, Cashflow)
- Investor Pitch Deck
- Most recent Board Report
- Detailed monthly Revenue and SaaS metrics (in Excel if possible) by customer/product/internally defined customer cohorts. Example(s): retention, churn, ARR/MRR, LTV.
- Growth plans (including the intended use of the proceeds), sales pipeline for 2022 and onwards, and confidence levels
- Statutory financial statements for the prior two fiscal years, if available.

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- Aged Receivables/Payables as at the most recent date available.
- Details on all loans/debt/quasi debt including outstanding venture debt, Grants/PPP/Covid supports, and any other indebtedness in the company and summary of the terms attached to same. For any Covid-related loans, please provide details and confirmation of forgiveness, etc.
- Fx & Banking Payments & Daily Banking – summary of bank accounts and any potential Fx exposures or hedging.

Corporate & Capital Structure

- Group Chart showing all subsidiaries, associates, investments, their jurisdiction, etc.
- Details of warrants, options, convertibles, and other "debt-like" instruments.
- Cap table.

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People

- ✓ High-level organizational chart showing headcount and FTE and leadership by division, entity, or location.
- ✓ Any material/notable agreements between the company and its shareholders, directors/employees, or related parties.

Product & Technology

- ✓ Product Demo or overview on platform/product roadmap with CAPEX required in the near future, disputes relating to IP or software (in or outside of court), any data protection or cyber incidents, etc.
- ✓ Pricing - Understanding typical contracts T&Cs, duration, sales cycles, GM, committed periods, etc.
- ✓ Patent documentation for any that is registered.

Material Agreements

- Summary and copies of any agreement's material to the company's business incurred outside the ordinary course of business or deemed potentially onerous.

Sundry

- Missed deadlines and disputes with tax authorities and tax payments outstanding.
- Details of ongoing or threatened legal disputes and administrative or regulatory proceedings.
- Overview of known events or developments which could have a material adverse impact on the business.

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Developing a Data Room

Any company raising money or selling itself needs to have a data room. A data room (or electronic equivalent) allows prospective investors or buyers to access crucial corporate information.

A data room can help address common questions that most investors ask when conducting due diligence. In addition, having your documents housed in one place can help demonstrate a structured, well-managed business. It can also ensure you control the story of your data while also limiting back and forth communication, which can limit the time you spend on your operations.

To help you develop your data room, our team has put together a list of items you may want to include. (Note that some of the following overlaps with our detailed guide above to what you'll need ready for investors to conduct their due diligence).

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Your Data Room

- Corporate overview deck
- Executive leadership bios
- Business Plans
- Product and service information, including roadmaps and pricing
- Technology investments
- Marketing plans, market research, strategies, and related materials
- Sales strategy and pipeline, including existing customers' MRR and ARR
- Company financials, including profit and loss statements and projections for the next year
- Amended and restated articles of incorporation
- Voting agreements
- Investor rights agreements
- First refusal & co-sale agreements
- Stock purchase agreements
- Capitalization table
- Details on previous raises
- Tax returns, audits, financial evaluations, and other reports from third-party professional service providers
- IP, including patents and trademarks
- Employee information, including compensation and contracts
- Legal agreements

Data Room Tips

When compiling the data, here are a few helpful tips to keep in mind:

Identify Your Audience:

Having all documents housed in a base structure is a significant first step, but you'll want to think about the different views, perspectives, and roles of the individuals evaluating your documents. You can create other sub-viewing structures and access rights to ensure that your targeted user only sees the items most important to their task.

It's also essential to tailor decks to the expectations of different investors. For example, lenders like to see ongoing cash management with lower risk. On the other hand, equity providers are used to seeing more aggressive plans where cash is spent quickly to get fast-paced growth (risky but rewarding if achieved), but this depends on what type of equity investor they are.

Lock it Down:

Be sure that all documents are secured and cannot be altered, copied, shared, or downloaded without permission.

Easy to Update:

Changes may happen. What might have been your corporate overview when you started setting up the data room may evolve. Make sure that you set up the data so that adding, removing, or editing documents is painless.

User Tracking:

Having insight into who has accessed what documents at what time and for how long will give you great insight into how your data room is being used. If you notice that certain documents are not being accessed, you can consider removing them from the data room.

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Communication Tool:

Your data room should allow for comments and questions and enable you to track notes made by users and respond through the communication platform.

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Building Your Funding Plan

Having your business intelligence gathered, organized, and ready to share is an important step. But it's also critical to have a plan of what you hope for, are willing to agree upon, and what to expect moving forward.

Understanding the Valuation

Understandably, every SaaS business wants the highest valuation. And in a world where so many companies are reaching 'unicorn' status with high valuations, , it's easy for founders to get a bit carried away, believing that their business deserves the level of valuation.

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(Lowering) Great Expectations

As many a parent has told a child, life often isn't fair. This adage holds for SaaS/software company valuations and most other industries. Small businesses typically receive some sort of haircut versus their larger peers for two reasons: size and liquidity.

- Size does matter – Larger companies have many safety qualities for investors that small companies do not have. For example, they have economies of scale, access to cheaper capital, talent, market access, etc.

- Likewise, private companies tend to receive an illiquidity discount because their shares can't be swiftly sold for cash. Exiting a privately-held company takes time and can be challenging.

It may not be fair, but mega-cap tech companies will almost always command higher multiples than small but mighty SaaS companies.

Now for Some Good News

As important as it is to temper founder expectations, the reality of SaaS valuations is positive. Privately held growing SaaS companies are usually valued somewhere between 2-10x annual recurring revenue, which most industries could only dream of. Indeed, for mature private businesses in other sectors, a multiple of 5-12x EBITDA is not uncommon.

Digging a Bit Deeper

As a firm that provides growth finance, we spend a lot of time evaluating SaaS companies' operations and finances. In this regard, we consider several metrics when deciding whether to offer a term loan. How a company performs on these questions can significantly impact its ultimate valuation.

This is a well-known tool, combining EBITDA percentage earned in a year plus revenue growth. The percentage growth in sales combined with the percentage of EBITDA should be 40% or higher. For example, a company growing at 45% annually and whose EBITDA margin is 5% would score 50 using the Rule of 40. This Rule of 40 should be taken with a grain of salt.

In SaaS, growth is the most critical metric, and burning cash in the pursuit of growth is a widely accepted way to run a business.

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The Customers are Always Right:

As part of our diligence process, we look at the quality of a SaaS company's customers. Our analysis looks at the number of customers a business has, the growth and expansion in this customer, and revenue concentration among the top purchasers. Digging deeper into a company's analytics can give valuable insights into the customer base, usage, open rates, daily clicks, and downloaded reports. These metrics detail how the customer uses a product, which drives decisions about how to cross-sell. This information also shows how "sticky" a product is from a risk perspective.

How your customer uses your product is important.

Gross margins:

This one is pretty self-explanatory. SaaS businesses with high gross margins are the most attractive, all else being equal.

One caveat, though: Companies can calculate their gross margins differently, with some excluding the cost of employees who are necessary to service customers. A good range is 75-85%, with necessary adjustments regarding how a company came to its gross margin calculation. Anyone with a gross margin of 98% either has the world's best business or is not calculating it properly.

Lifetime value/CAC Ratio:

Virtually every SaaS company has to spend money to make money. But it's important to take a hard look at how sales and marketing dollars translate into revenue. Businesses can do this by estimating the lifetime value of a customer and dividing that figure by the Customer Acquisition Cost (COST). This gives you an understanding of the base profitability of your business at a customer level and is a great indicator if you are spending and pricing your product correctly. Again, scoring three or higher is ideal.

Once you have a better understanding of the potential valuation of your company, it's time to begin to consider all the different ways an investment may be structured. Again, the exercise will help you determine what you are comfortable with and items that could put your profits at risk.

Structuring the Investment

As the saying goes, you plan to fail if you fail to plan. With this in mind, there are a couple of critical strategic questions every founder should think about before they raise money:

1. **How much should I raise?**
2. **What will I do with the money?**

These questions are related. For example, say you could raise $20 million but can only efficiently spend $5 million to grow your business. We would suggest that you're better off only taking $5 million. The last thing you want to do is take money at a super-high valuation and then let a massive portion of it sit on your balance sheet or be wasted spending ineffectively.

Investors want to see you spend the money you've raised to grow, and they won't be impressed if they write big checks only for the money to lay idle. Moreover, you'll be doing yourself no favors by simply aiming for the highest near-term valuation: If you can't use the funds to grow quickly, the next raise could be the much-dreaded down-round, which no founder wants.

The main advantages of equity financing are:

a) The size of investment is usually large compared to the size of the company and

b) That there is no obligation to make repayments out of cash flow, as the VC or Equity investment looks to get exceptional returns through the company’s sale or IPO.

However, with significant equity raises comes a loss of control, preferential rights for the VC investors, and potential conflict over strategy.

Founders should think about the company's corporate structure and how an investor could look to structure the investment.

There are multiple items to consider:

- Common Shares
- Voting Rights
- Preference Rights
- Restructuring of the organization
- New board members
- Warrants


$200 million shareholders

Here's why these considerations can be so important. As a founder, say you've taken on $100 million from equity investors who received preference shares, and your company is ultimately sold for $200 million. So far, so good. But if those preference shareholders are entitled to two times their investment before common shareholders receive any return, you're out of luck. The entire $200 million will go to those shareholders, and you'll receive nothing for your equity. Long story short?

The devil is in the details! Have an idea of what is acceptable to you and what is not before starting the discussions. To see an example, check out A Standard and Clean Series a Term Sheet: Fundraising, Fundraising Docs, Series A | Y Combinator

To compare the total cost of capital on loans with equity warrants,use the free Cost of Equity Warrants Calculator

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Finding the Right Investor

Investors aren't created equal.

As a start-up, you'll want to sit back and think about which companies or funds are the ideal parties from whom to raise money. You may want to consider factors such as:

Geography:

A U.S. VC fund may not be your best bet if you're a company domiciled in Asia. They'll probably stick to investments closer to home and might not understand your business if the customer is more locally based.

Specialization:

Let's say you're an emerging food tech company. In this case, an ideal investor may be either a large food company such as Kraft or a VC fund focused on nutrition ventures. Not only will these kinds of shareholders give your outfit added credibility, but they'll also have the expertise to help you grow. By contrast, a generalist investor may only be able to write the check; They may not have the knowledge or industry connections to be a key partner for you.

Questions to Ask Before Taking Equity

1. What track record of companies has the VC invested in?
2. What percentage of the fund is this investment?
3. Do they typically take board seats?
4. What are the reporting requirements?
5. How do they add value (outside of the investment)?
6. How do you handle potentially competitive situations?
7. What does the diligence process look like?
8. How far into the fund's life is the investment coming?
9. What preferential rights will the VC have over other investors or founders?

Issues to be Aware Of when taking Equity investment

Taking equity can create dilution and internal business operation conflicts resulting in risks to the founder. Here are some common practices and occurrences that can derail your company:

1. The common practice of prospective investors "chipping away" at the proposed valuation. For example, they may offer a specific price per share, and then as diligence items come up, seek to reduce what they'll pay for their stake

2. The risk of preference shares, where equity investors will get back 2X their investment before founders are paid any deferred proceeds from selling shares.

3. Equity investors can look to charge management fees to companies they own for their board and strategic services; They get paid before any other shareholders.

4. Loss of control in every way: Equity investors will want to have the final say in all major decisions in the business, including who is running it, even if they are a founder.

What to Expect After the Raise

Congratulations, you've managed to do a successful equity raise! Now what? If this is the first time you've taken on outside investors, things will be a bit different from here on in:

- You'll need to send out monthly updates to your new shareholders
- Managing investor relationships will become a new part of your job
- The chances are that some of the new shareholders will request board seats and may also get an outsized say in your business plan via so-called super-majority rights
- You will have to manage and align goals and deliverables and track the business for your new partners.
- Your business may receive more attention from business media, so you'll want to have an effective public relations strategy
- Despite the new responsibilities that come with an equity raise, you'll still need to keep your eye on the ball (i.e., the actual running of the business)

The Last Word

If all this information seems daunting, fear not. Equity raises are done all the time and back lots of companies with many differences. Founders and their companies need to plan, be as organized as possible, and understand their funding options.

Here at Element Finance, we know that equity and debt are two sides of the same coin. However, raising equity in exchange for shares in your company is not the only way to fund a business.

Venture debt can be an alternative to an equity raise for fast-growing early-stage SaaS companies needing working capital to fund expansion, acquisitions, and sales and marketing investments. Using debt for growth allows founders to scale their company while reducing the cost of capital and limiting dilution.

As the business matures, applying the correct dosage of debt into the capital stack can help lower the overall cost of capital, get shareholders the best return on the company's assets, and minimize unnecessary dilution.

Element Finance is a boutique growth finance company that invests in and lends to SaaS & recurring revenue companies.

Our growth finance helps bridge the SaaS funding gap through revenue-based finance and fixed-rate term loans. Our straightforward finance options are customized to the needs of the business with no hidden terms and conditions, board seats, personal guarantees, or equity.

Talk To Us