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Corporate Finance

Start-up Funding

Nuances of Start-up Investing

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Snapshot

Background

With job seekers turning job creators, the Start-up culture continues to flourish in the ecosystem. The Department for Promotion of Industry and Internal Trade (DPIIT) defines a Start-up as an entity:

- incorporated as Private Limited Company or Limited Liability Partnership or Registered Partnership Firm and not having been formed by splitting up or reconstruction of an existing business
- in existence for less than 10 years from the date of incorporation
- with annual turnover not exceeding INR 100 crore in any of the financial year since inception
- working towards development or improvement of a product, process or service and/or having a scalable business model with high potential for creation of wealth and employment

In order to avail various benefits under the Startup India scheme, an entity is required to be recognized by DPIIT by registering on it portal.

Building on to the above, an entity can be branded as a Start-up if it possesses a fledgling business model with attributes of sustainability, scalability, innovation and disruption as its core objectives.

At the inception stage, Start-ups typically fund their underlying idea or prototype either by bootstrapping or by raising funds from family, friends and relatives. However, in order to scale up, Start-ups need multiple rounds of follow-on external funding.

Key questions at the funding stage include – Why would an investor make a high risk seed funding? How does an investor trade-off risk with returns? How would an investor value a Start-up? What aspects are investigated by an investor before investing? Read on for the answers!

Recent trends in Start-up funding

It usually takes 2 to 3 months of time from making a pitch to closing an investment. However, this could get stretched if the Start-up is not well prepared in terms of the busines plan, financial model and valuation expectations.

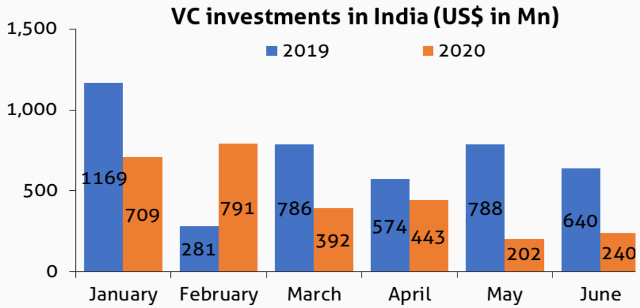
VC investments, both in terms of number of deals and value of investments, witnessed a decline in 2020 as compared to 2019 primarily owing to the aftermath of Covid-19 pandemic.

VC investments in Indian Start-ups increased at a brisk pace until February 2020 as compared to the same period last year before starting to decline from March 2020 onwards.

The number of deals fell from monthly average of 50 deals between January 2020 and April 2020 to 20 in May 2020 with the amount invested in May 2020 comprising only one-fourth of the investment made in May 2019. However, some green shoots were visible in the first half of June 2020.

Fintech, healthcare, education and food tech space attracted major investments in the first half of 2020. In less than six months of 2020, ed-tech start-ups have already raised more than 90% of the total investments it raised in 2019. However, e-commerce sector lost its ground as it could only raise c. 20% of the total amount it raised in the first half of 2019.

Unless the deal activity picks up in the second half of the year, most VC investors are expecting a sharp decline in number of deals this year.



Source: Livemint; Venture Intelligence
Note: Data for June 2020 is until 16 June

Seed funding

The initial capital raised by a Start-up is referred as angel or seed funding. Angel investors are typically high net worth individuals whereas seed investment is made by funds. Angel or seed funding is required to sustain and survive at a time when either the business is in the prototype development or testing phase or it has just started generating some revenue.

Investors look at various factors while selecting a start-up for funding such as the idea or the concept and its scalability, level of technology dependence, growth of other similar start-ups, intellectual property involved and above all the quality of management team.

Some essentials to attract funding include:

- A scalable business model
- Key differentiating factor of the product or service offered
- An efficient management team
- Size of the target market and possibilities to penetrate and augment the market share
- Existing competition and/or potential entry barriers
- Purpose and amount of investment
- Ability to deliver significantly high returns
- Valuation expectations to be in sync with the business model

Having said that, overinvestment in earlier rounds does not bode well for a Start-up as it increases the burden of generating higher returns over the next 3 to 4 years by diluting higher ownership stake upfront.

Once an investor is convinced with the business model, the next critical aspect is to determine valuation, which is driven by the future cash generating capacity of the business, comparable valuation of similar businesses, intellectual property involved, ability to scale up fast and a clear path to profitability.

Subsequent funding rounds generally build upon the valuation fundamentals determined during the initial stages of funding.

Start-up valuation

Valuation matters a lot to the founders as it determines the ownership stake to be diluted in return of the investment. At the cost of sounding cliched, valuing a Start-up is more an art rather than science. In the absence of historical financial and operational data to depend on, investors need to rely on intuitive approaches to determine valuation in case of start-ups.

Key determinant of valuation is the strategic advantage that a Start-up possesses including the target market size and market share, scalability of demand for the product or service, level of competition and a differentiation advantage.

Further, if a Start-up is operating in a market which is relatively less saturated and the outlook for growth is high, it gives an investor all the more comfort on placing bets at higher valuations to avail an early mover advantage.

While investors and analysts possess multiple models of valuation, including ones that involve qualitative variables and complex statistical analysis, the most widely used methods include

- comparable valuation multiple analysis
- precedent transaction analysis
- discounted cashflow analysis

Talking about the discounted cashflow (DCF) method of valuation, it derives the value of a business based on its future cash generating capacity, which suits a start-up that may not have much of historical performance to showcase.

Future earnings are subject to uncertainty, and hence it needs to be discounted to address the time value of money and the inherent risks of investing in a non-tested business model. Discount rate is directly proportional to the level or risk perceived and valuation is inversely related to the discount rate. Discount rate used for valuing a Start-up is significantly higher than the weighted average cost of capital generally used in valuing stable and mature businesses.

As DCF method is a mathematical formula which is sensitive to various variables underlying the assumptions in relation to the future earnings, it is always advisable to perform a sensitivity analysis of such variables. Further, investors also deploy scenario analysis (e.g. base case vs worst case vs best case) to understand a broad of range of valuation.

Due diligence

Valuation is often tested at the due diligence stage where an investor takes a deep dive into various aspects of business such as financial, operational, commercial, legal, compliance, intellectual property, employees, technology, etc. The focus is on independently testing the key drivers and assumptions including validation of recent facts.

While there is no standardised due diligence approach, the coverage depends upon the requirements of the investor and the nature of business. The scope may undergo a change even during the progression of the diligence exercise.

As an outcome of the due diligence exercise, the valuation may undergo a change subject to negotiations between the investor and the founders.

Key aspects of due diligence include:

Financial due diligence focuses on reviewing the historical financial information to assess the underlying performance of the business. Key scope areas include revenue, earnings, working capital, capex, cash flows and debt.

Commercial due diligence entails review of the business plan including assumptions underlying the financial projections from the perspective of market demand, customer continuity, competitors, supply chain, other operating metrics and cost assumptions.

Tax due diligence focuses on assessing an effective tax structure, cashflow impact of tax exposures, continuity of tax benefits and review of tax compliances.

Legal due diligence includes examination and review of the charter documents, title documents, agreements with customers, suppliers, lenders, shareholders and employees, business licenses & permits, periodic statutory compliances, regulatory filings, litigations, insurance coverage, environment, health & safety, human resources, intellectual property rights, among others.

Investor protection rights

While an investor allocates valuable capital (at times, even borrowed from other investors) to a Start-up with an expectation of financial returns, the investor being a co-owner also requires enough protection from downside risks as the investor would not be in a position to control the business on an ongoing basis.

Investor protection rights are spelt out in the Investment Agreement and primarily cover the following:

- Investment through instruments such as convertible preference shares having voting rights as well as dividend and liquidation preference
- Representation of investor on governing body e.g. board of directors
- Veto powers to the investor on key business and strategic matters
- Pre-emptive rights to secure dilution of stake going forward
- Anti-dilutive protection from any erosion in the value of investment in future rounds
- Restriction on transfer of shares by promoters including a right of first offer/ refusal (ROFO/ROFR) to the investor
- Tag-along and drag-along rights to secure a smooth exit including in case of any default by the promoters
- Information and inspection rights for reviewing the performance of the business
- Representations and warranties from the promoters duly protected by an indemnity mechanism in case of any breach
- Non-compete and non-solicitation undertaking from the promoters to protect business interests
- Exit mechanism through initial public offering (IPO), buy-back, secondary sale, put options, etc. entailing minimum return expectations typically upward of 25% p.a.

Cash burn rate

As Start-ups are expected to bring innovations and cause disruptions in a specific domain, it is pertinent to note that significant investments are required to be made in areas of product and process development, recruiting the right talent, initial and growth working capital, technological infrastructure, customer acquisitions, and enhancing the market share quick and fast.

As such, in the initial years of existence, a Start-up ends up burning cash as the revenue from business is not enough to cover the operating expenses and / or growth related investments. Consequently, start-ups face liquidity crunch in its early days, which is why seed funding proves to be a lifeline for a fledgling business.

Analysing cash burn rate is an effective tool to estimate the requirement of cash in the near term vis-a-vis the availability of funds. It also assists the promoters to foresee a cash runway which acts as a yardstick of solvency. Cash burn continues until the business attains a cash breakeven position generally upon scaling up of revenues.

Needless to mention that during this process of upheaval, a Start-up has to pass through stages of high employee attrition, lack of loyalty from customers and business partners, regulatory oversight, etc. which may prompt the founders to pivot the busines model with agility.

More often than not, angel and seed investors act as mentors to the founders while guiding them to overcome financial and operational challenges.

Conclusion: Growth vs Profitability

Investors chasing high growth are not deterred by the cash burn as they continue to fund growth initiatives even if it means incurring losses in the near term. Start-ups, including the Unicorns (valued above US$ 1 Bn), defy the conventional logic of valuation based on profitability.

What is referred to as a loss in the accounting terminology is considered to be an investment for future growth by venture capital investors. This is the nuance of investing in Start-ups. As such, Start-ups continue to raise larger rounds of funding with valuations soaring upwards even as their losses widen. To name a few

(Source: Livemint)

- Digital payments firm Paytm posted a loss of c. US$ 250 Mn in 2016 when it was valued at c. US$ 5 Bn. In 2019, while its losses soared to US$ 600 Mn, its valuation tripled to c. US$15 Bn.
- Swiggy, the online food delivery start-up posted a loss of c. US$ 25 Mn in 2016, when its valuation was c. US$ 250 Mn. In 2018, its loss increased to c. US$ 60 Mn with valuation also increasing to US$ 1.4 Bn.
- Similarly, homegrown e-commerce giant Flipkart's losses increased from c. US$ 90 Mn in 2016 to c. US$ 300 Mn in 2018, despite which Walmart acquired Flipkart at a valuation of US$ 21 Bn.

The key takeaway from the above examples is that investors value high growth start-ups based on their revenue generating capacity and not necessarily profitability in the near term. It is worthwhile to note that a significant portion of the investment goes into funding customer acquisition and marketing costs, employee costs and investment in technology infrastructure which directly contributes to the value added in the economy.

The last thing that the Start-up ecosystem needed was a pandemic, which aggravated the operational challenges including the liquidity position. Although optimistic about the long term growth story of the Indian Start-up ecosystem, investors have turned cautious in the wake of the pandemic and have shifted from a growth at all cost mindset to a path towards profitability backed by unit economics.

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