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How early-stage startups raise money

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Options include going to friends and family, crowdfunding, dipping into one's savings, or, if one is lucky, finding an angel investor

BENGALURU: The first 'round of funding' Abhishek Latthe got when he was setting up his wearable device startup SenseGiz in 2013 was from his family and friends. The next year, he set up a crowdfunding page on Kickstarter and raised $47,000. Late in 2014, he took out a bank loan. It was only two years later in 2015, that he could convince Karnataka Semiconductor Venture Capital Fund to back him with Rs 3 crore.

Indian startups have attracted billions in private equity and venture capital funds from across the world, but early-stage startups — those that haven't yet started raking in revenue — s truggle to raise funds. Banks do not back companies without collateral and since the business model is unproven, other investors too hesitate. So, funding options include getting help from friends and family, crowdfunding, or dipping into one's savings, but how do founders decide on the path to take?

"Choosing from the options can be tricky. It depends on the company's financial needs. We went with friends and family at the earliest stage because it was difficult to raise a VC round. We chose crowdfunding when we needed publicity for our product," says Latthe.

Mandar Gadkari, head of investor engagement at Cross Border Angels (CBA), an international investment platform that helps

startups secure cross-border deals from angel investors, says the friends-and-family route is a good option for initial capital infusion. "Investors look for your skin in the game. Having internally-funded your startup gives them confidence to invest. A bootstrapped or seed funding round increases your chances of getting a follow-on round," says Gadkari.

Although bank loans are an option, startups, especially in the technology space, avoid them due to the high interest rate and need for collateral. The natural progression for a startup is to bootstrap, and then look for a professional angel investor.

Government grants are an option if the startup operates in a sector that needs the government as an agent. Leo Mavely's medical device company Axio Biosolutions is one such example. It was relatively easy to get grants and funding from the department of science and technology as the armed forces is its biggest client.

Gadkari says peer-to-peer lending and bridge funding, which fulfil a company's short-term working capital needs, have also become popular. Choosing the best funding option depends on the company's need. The next step for an entrepreneur is to negotiate the company's valuation.

Negotiating with investors is all about playing hardball. Abey Zachariah, founder of Goodbox, an app platform for SMEs, made sure that he didn't give up more than 10% of his equity while raising angel investments in 2013. "Angel investors often ask for more stake than the money they give. You have to ensure that you don't give up more than 10%," he says.

Sometimes, entrepreneurs and investors are unable to reach a conclusion on the valuation of the startup. Giving up equity then becomes an issue. To work around this, convertible notes or compulsory convertible debentures (CCD) have become popular in the startup community.

Convertible notes are a hybrid form of venture equity and debt. The investor loans money to the company without arriving at a valuation figure. The promise is that the loan will be converted to shares when the company raises its next round of funding from a mature investor. If a follow-on round doesn't take place, then the money remains a debt for the company. CCDs are a form of convertible notes, where the loan necessarily has to convert into equity after a certain period of time. These have been used regularly in Silicon Valley and Singapore, but have been gaining popularity in India from 2016.

Harshita Srivastava, head of venture capital investment at Nishith Desai Associates, says convertible instruments are the preferred option for foreign investors in India. "Among convertible instruments, CCPS (compulsory convertible preference shares) is the most favoured because it allows the investor a preferential right to dividend and a preferential right to recover investment in case of liquidation. While CCD is another option, it is primarily a debt security and sits as a loan on the books of the issuer company, with an agreed rate of interest," she says.

Srivastava says foreign investors have been choosing convertible notes after the RBI issued a notification dated January 10, 2017. "Considering the challenges around establishing the valuation of an early-stage startup, RBI came up with the notification which allowed startups (recognised under the government's startup policy) to issue convertible notes to incoming investors. Pursuant to the notification, a lot of the non-resident angel investors are keen to invest in convertible notes since the instrument gives the option holder a right to convert into equity in conjunction with a future funding round. Startups too have become more comfortable with the idea of convertible notes."

Latthe of SenseGiz went for this option when he raised his VC round in 2015. His tender lasted three years — he need to raise another follow-up round within three years to convert the previous fund of Rs 3 crore into equity shares. He is in talks with a late-stage VC to complete another round before the three-year period runs out.

India seems to lag behind markets like Europe, Singapore, and the US in terms of methods to raise funds. It is yet to regulate crowdfunding, and bank loans are still given at a high interest rate of 14-16%, far higher than Japan (1-3%) and China (4-6%).

CBA's Gadkari says it is critical for the government to come up with guidelines to promote not just angel investment but also corporate investment in startups. "It will take a few more years for it to become easier for Indian startups to raise funds," he says.