Anthony Law

IP and Technology

Corporate

Mergers & Acquistions

Anthony Law, LLC
383 N. Front St., LL
Columbus, Ohio 43215
614-340-0011
614-340-0012 FAX
Andrew H. Stevens, Esq.
ahs@anthonylawllc.com

ADVISORY MEMORANDUM

Re: What's the difference between the seed round, Series A, Series B, and Series C?

I. Introduction.

Companies raise money in several different phases. These phases are commonly divided into the following rounds: Seed, Series A, Series B, and Series C (additional rounds added if necessary). Each round attracts different types of investors and generally raises a higher amount as each round passes. In general, companies use the funds from each round for certain types of business activities. A detailed breakdown of each of these phases follows.

II. Legal Considerations.

Many venture capitalists will walk away from a deal if the capital structure is a mess. Federal and state laws regulate raising even small amounts of money. State and federal securities laws and regulations apply to all of the rounds discussed below. These laws and regulations include requirements pertaining to the advertisement, registration, and sales of securities. Securities include shares, equity, or debt in a startup, including when these are sold to family and friends. Federal and state laws regulating advertisement, registration, and sales of securities include a variety of exemptions for situations when companies generally only raise money from family and friends as well as when raising funds from accredited investors. Aside from securities laws, it is critical that companies maintain proper organizational and fundraising documents. Not only can issues with these documents amount to violations of federal and state securities laws and cost huge amounts of money down the road, but deficiencies in these documents could also potentially derail subsequent attempts to raise additional capital.

II. Fundraising Rounds.

A. Family and Friends Round. Although experts vary on this point, this round is the first fundraising round used by startups. Some argue that the seed round includes friends and family.

Often the easiest and most accessible group of investors are the founder's family and friends. This round is easy and quick to complete, providing the company with quick access to funds. This round usually only takes two months from start to finish. Generally, companies raise $25,000 to $150,000 in this round. The family and friends round is not always necessary, sometimes founders are capable of self-funding the company during this phase.

B. <u>Seed Round</u>. The Seed Round is usually the first round of fundraising to involve sophisticated investors such as angel investors. In this phase, the founders may still be trying to establish a direction and set of goals for the business and may not even have a finalized product yet. Funds raised in the seed round are usually used to help bring the product to market. As with the family and friends round, the seed round is not always necessary. Some companies will already have the resources and will not require a significant initial investment to get the product to market. For other companies, the seed round may be critical in bringing the product to market. Companies usually raise between $250,000 and $2 million in this round from a combination of angel investors, super angel investors, and sometimes, early-stage venture capital firms. Companies usually try to meet at least one of the following goals during this round:

1. Product Identification – transform an idea into a product; finalize design elements; finalize a product for launch

2. Marketplace Orientation – market research; understanding competition; identifying and developing product and company selling points; identifying the niche that the company will sell in

3. Demographic Testing – identify specific demographics and target customers for the product

4. Team Creation – bring in the right employees to fill gaps in expertise and needed skills

C. Series A Round. The Series A round allows companies to raise more money from investors to take the business to the next level. The Series A round is usually the first fundraising round to use significant outside capital. Series A investors are generally traditional venture capital firms such as Sequoia or Accel. Angel investors can also participate in Series A rounds, but angel investors generally do not have any power to set pricing or deal structure. Pricing and deal structures are usually dictated by the venture capital firms. Series A rounds usually yield investment amounts ranging from $2 million to $15 million. Companies usually try to meet at least one of the following goals during this round:

1. Establish or Modify Business Plan – implement business plan to meet defined business goals; modify existing business plan with newly defined business goals

2. Distribution – figure out or scale distribution; optimize advertising and distribution (can lower costs, increase sales, or both)

3. New Markets – launching product in new region or market; scale geographically or across verticals

4. Shortfall – make up any shortfalls in capital; funds help to offset unforeseen expenses

D. Series B Round. At this stage, the company is usually well on its way to being an established business, production is well managed, advertising and sales are in full flow, and customers are actively purchasing the product. Scalability is the main focus of this round. Series B rounds are usually funded by traditional venture capital firms and with the addition of venture capital firms specializing in later stage investments. Series B rounds are often led by the same firms that led the Series A round. Amounts raised during a Series B round can range from $7 million to tens of millions. Companies usually try to meet at least one of the following goals during this round:

1. Team Expansion – more employees may be needed to handle growing day-to-day tasks; expansion of office facilities; scale existing business model

2. Globalization – capital is often needed to establish a company on a national or global scale (typically, prior to this stage the company is only selling in a few regions)

3. Acquisitions – Acquiring other businesses or intellectual property to expand product offerings or to increase operational efficiencies

4. Scale Customer Base – expand customer base to new demographics or regions or countries; expand product to reach new bases of customers

E. Series C Round. Series C rounds and beyond (Series D, E, F, and so on) are not always used. When they are used, these rounds are designed to raise funds for specific needs. Common goals of these rounds are to continue rapid growth and expansion, expand to international markets, and make further acquisitions of other businesses or intellectual property. These rounds typically attract traditional venture capital firms, late stage venture capital firms, private equity, hedge funds, and investment banks. The amounts raised are normally at least in the tens of millions up to hundreds of millions.

III. Other Considerations.

Founders should consider several issues when moving through the fundraising process above. Maintaining realistic expectations, especially when pitching to early investors such as family and friends, can help to control investor expectations. 90% of new ventures fail during the startup financing phase (family and friends round) while 60% fail even after raising money from venture capital firms. It is also important to remember, that even though a founder's ownership may be diluted throughout the fundraising process, a 10% ownership stake in a large, successful company is much more valuable than a 100% ownership stake in a company that failed.

i. Things to Avoid: Overvaluation. The fundraising process has many pitfalls, each of which could doom even the most promising companies.

Overvaluation can significantly impair a company's ability to raise funds in later rounds. When a founder overvalues an early round, it can be significantly more difficult to raise money in subsequent rounds as potential investors question not only the valuation but also the company's ability to grow and execute. Down rounds are rounds where a company raises money at a lower valuation than an earlier round, and down rounds can spook investors.

ii. Valuation Techniques. While many techniques exist for valuing a startup, industry experts usually turn to the same few methods. It is important to keep in mind that a company's valuation is the value that investors arrive at, not the value that the founder puts on the business. A startup is only as valuable as the valuation number that allows the company to successfully raise the required amount of capital. A key to valuation is profitability. If a company continues to struggle to turn a profit, that business will be valued significantly lower than a business operating in the black.

Newer companies do not have lengthy histories of its financial performance; therefore, investors often rely on two valuation methods, comparables and financial forecasting. The comparables method involves finding similar companies in the same industry and geographic location and determining their valuations. This can be done based on how much the comparables have sold for recently or are currently being advertised for as for sale. Sites such as bizquest.com and bizbuysell.com can be good indicators of the valuations of comparables. Certain companies, like technology companies, are often harder to value.

Financial forecasting is the other primary valuation method. With financial forecasting, valuations are based on a multiple of future financial figures. For example, a valuation could be calculated by taking the company's EBITDA and multiplying it by the appropriate multiple. Multiples are usually dependent on several factors, including industry, company size, and geographic location. Multiples can range from 3x to 20x, NYU's Stern School of Business publishes updated data of multiple ranges by industry. The data can be found at http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/vebitda.html. For early startups that have no earnings, revenues can form the basis of this calculation, however, this method is more commonly used to value established companies.