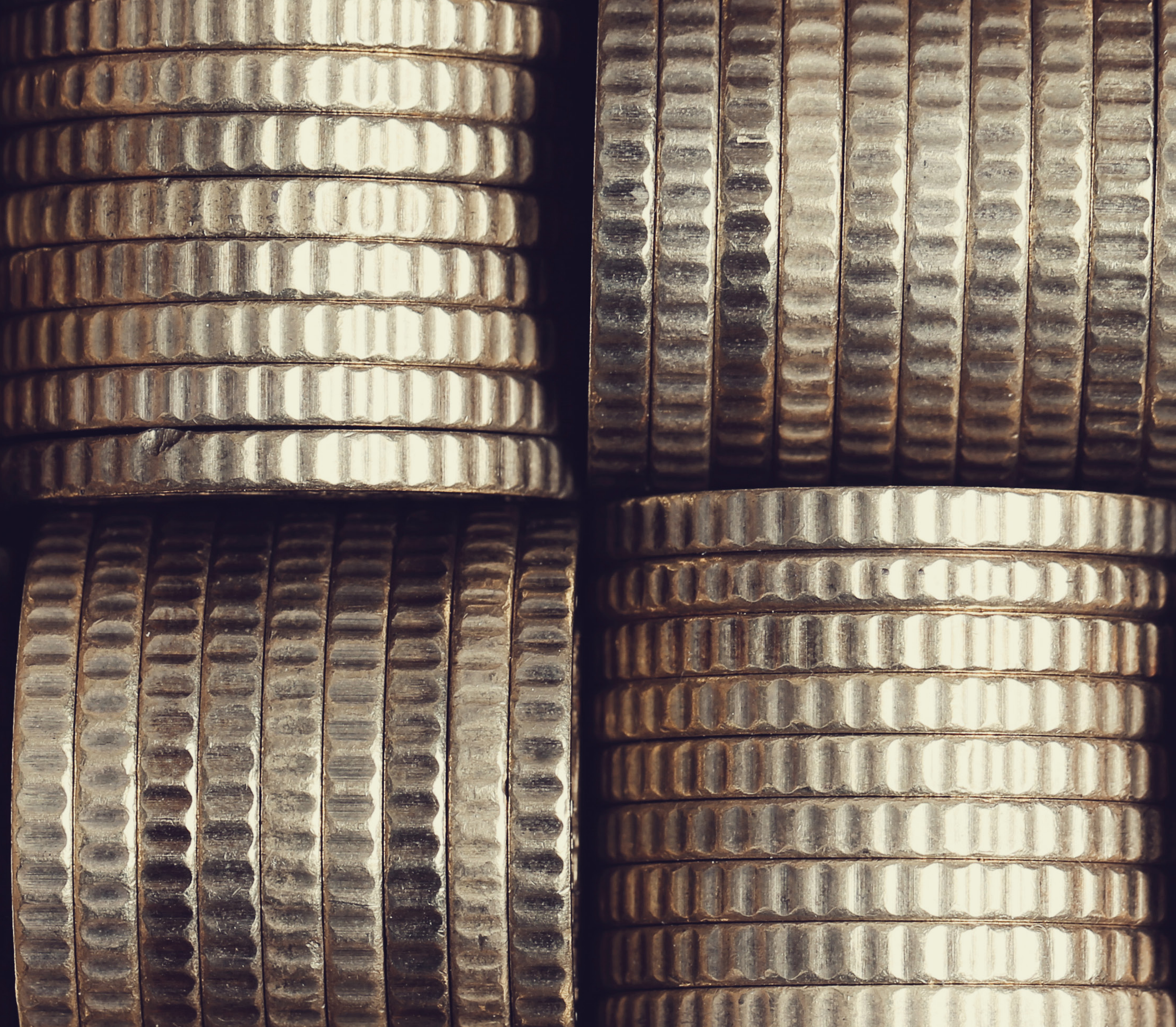

Venture capital: investing in the growth of startups

2023

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Financing growth: an introduction to Venture Capital

In the world of investments, one specific sector attracts the attention of most start-ups: venture capital. In this sector, investors invest money in young companies to finance their growth. These can be early-stage startups as well as companies that have been around for some time and have now gained recognition. The aim of the venture capital investor is to help the company achieve its growth goals in order to eventually make (more) profit. In this article, we discuss the key takeaways of venture capital, such as the relevant parties, the different growth phases, the financing methods, the major pitfalls of investors and entrepreneurs and how BUREN could assist.

Venture capital: who are the key players?

Let's start with the relevant parties in the venture capital world. On the one hand, there are the investors, also called venture capitalists. They are often professional investors who focus on investing in young companies with high growth potential. These include the well-known group of FFF (friends, family and fools, or also jokingly called the foolish friends and family), incubators, business angels and venture capital funds. On the other side there are the entrepreneurs, the directors (and often still some shareholders) of the startups being invested in. There are also intermediaries, such as lawyers and financial advisers, involved in the company's investment and funding rounds.

From idea to success: the different growth stages of startups

The financing of a startup's growth often goes through several stages. The type of investor involved depends on the stage the startup is in.

Seed phase

The first phase is also called the seed phase; a very early stage of the business. In this phase, (relatively) small amounts of money are raised, generally by FFF, incubators and/or business angels. This phase is often used to develop a product or service and test whether there is demand for it on the market.

Startup phase

If there are positive results (for instance market demand, there is usually no profit at this stage), the company moves to the next phase, the startup phase. This often involves investing more money and further building the company based on, among other things, data. The input and experience of investors can accelerate this development. Venture capital funds (early stage) are often interested from this stage onwards.

Growth and expansion phase

This is followed by the growth phase where the company starts to grow and become more and more well-known. This can lead to the next phase, the expansion phase, where the company can roll out its product or service on a large scale and increase its market share. FFF and business angels are often replaced in the growth and expansion phase by more professional and larger venture capital funds or even private equity funds. Finally, the company can advance to the maturity phase, where it has reached its market-leading position and is profitable.

Smart financing: different investment and financing types in Venture Capital

There are various options to invest in a startup, such as contributing equity versus issuing shares, providing a loan (convertible into shares), or agreeing a SAFE (simple agreement for future equity). Each of these investment options has its own advantages and disadvantages, and it is important to understand how these can affect the position of the entrepreneur and investors.

Equity
An equity investment is the most common form of investment by venture capital funds and business angels. In return for the investor's investment in the company's equity, the investor receives partial ownership of the company in the form of shares.

The advantage of an equity investment is that the interests of the investor and the startup are aligned, as both parties benefit if the venture is successful. Furthermore, in the event of a successful sale (exit) of the company, such as an IPO (listing at stock exchange) or an acquisition, the investor can receive a significant return on its investment.

However, the disadvantage of equity investments is that they can dilute the ownership of the startup's founders and other early investors. Furthermore, equity investments usually require more legal and financial resources to finalise a transaction than convertible loans.

Convertible loans
A convertible loan is another type of investment often used in venture capital. It is a debt instrument that can be converted into equity at a future time, usually in a future financing round. In doing so, the investor will often want to negotiate a discount on the price to be paid upon conversion as consideration for the risk of the investment.

The advantage of a convertible loan is that it is a flexible instrument that can be agreed quickly and does not interfere with the development of the business. The entrepreneur can therefore get back to business quickly. This contrasts with the process involved in a capital investment. That process may be delayed by various administrative, bureaucratic, legal or notarial procedures. Furthermore, with a convertible loan, it is often agreed that the investor can participate in future funding rounds on the same terms as new investors.

While a convertible loan allows the startup to raise capital quickly and cheaply, it can be more expensive because the startup owes interest on the loan. Moreover, the equity interest of the incumbent investors may be significantly diluted if the startup raises a lot of capital in the future and the investor obtains a significant share of the equity through conversion.

SAFES
SAFEs are another type of investment that enables startups to raise capital. The main advantage of SAFEs is that startups can raise capital without valuing their business. This is especially useful for startups that are struggling to value their business, for example because they are developing a new product. Moreover, SAFEs are faster and cheaper to finalise than capital investments and often have fewer requirements.

However, with SAFEs, the investor bears a significant risk as he is not guaranteed a return until a future event occurs. This risk can lead to the loss of the entire investment.

In the Netherlands, SAFEs, as well as the similar instrument that fits better within the Dutch market and legal system, namely the "easy prepayment on shares", are not or hardly used.

Debt financing
While loans can be a form of funding for startups, it is important to note that they are not always the best option. Loans can be harmful to a startup's growth because they often charge high interest rates and lenders may require collateral. Entrepreneurs need to be careful with that collateral, especially security on intellectual property, as the lender can enforce (i.e. sell) that collateral once there is a (payment) default under the loan. Furthermore, loans often have fixed repayment schedules, which can put pressure on the startup's cash flow. Debt financing therefore is basically not attractive before the business is in the expansion phase.

Pitfalls in Venture Capital: Risks for investors and entrepreneurs
While venture capital can be a great way for startups to fund their growth, entrepreneurs and investors should also watch out for pitfalls.

Investors
Because a startup often exists for only a short time, thorough research is not always possible. A pitfall for investors is that they put too much emphasis on the technology or idea behind the company and too little on the team within the company. A good team is in fact essential to the success of a startup because it can bring the idea to life and ensure that

the company can grow. It is also important that the technology is legally owned by the company and possibly protected by a patent, for example.

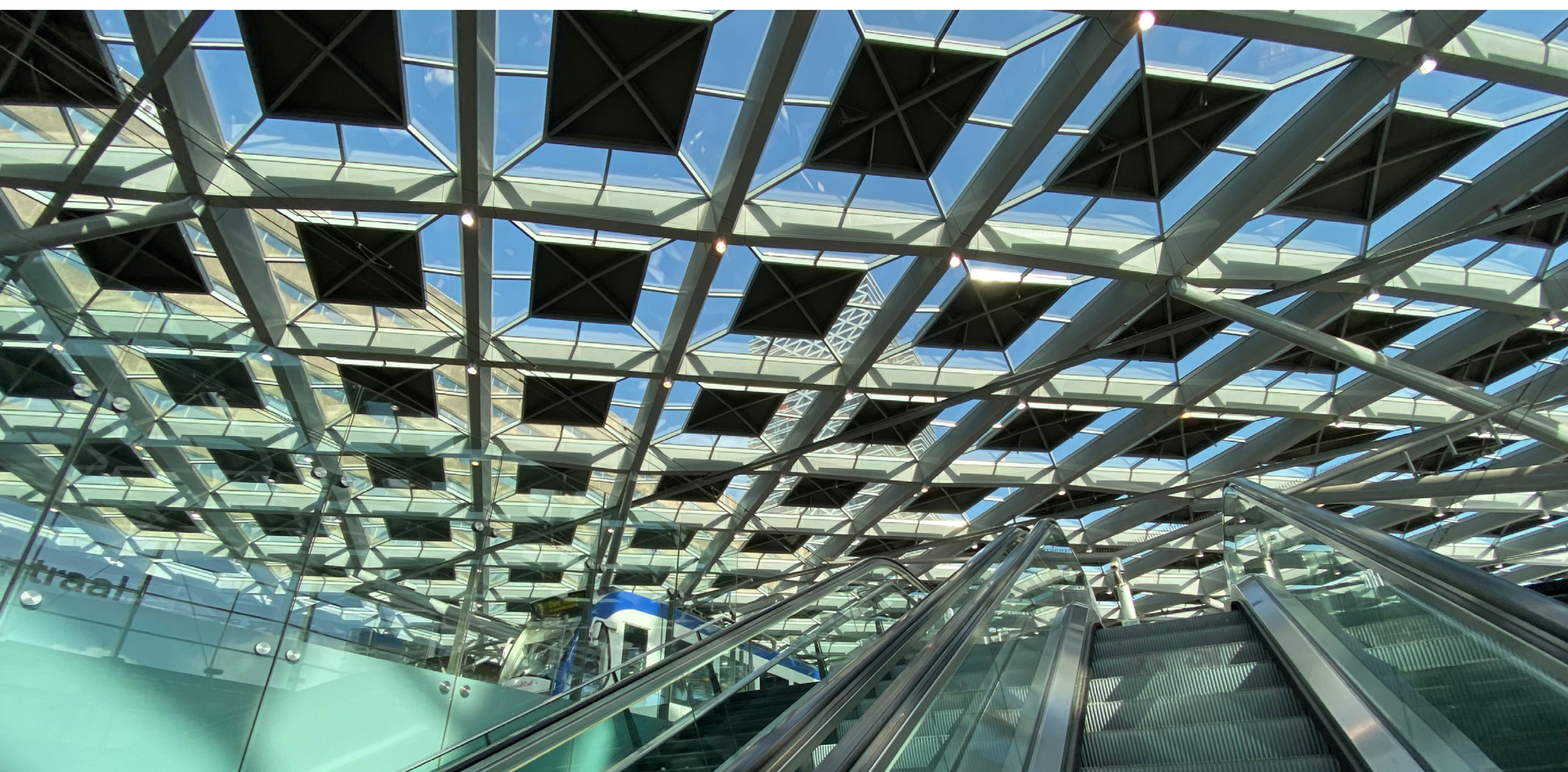
Another pitfall for investors is investing too much money in one company, which means their portfolio is not sufficiently diversified. This can lead to higher risk and potentially large losses. On average, only 1 in 10 investments in startups yields a profit of more than x10, and many startups generate losses for investors.

Entrepreneurs
A major pitfall for entrepreneurs is that investors want too much control over the company, leaving the entrepreneur with too little control. In addition, investors may be more focused on short-term profits than on the company's long-term vision. This can lead to tensions between the entrepreneur and the investor. It is also possible that too high a valuation is set in the investment round, making it difficult for the company to realise this value later on. A good alignment between the interests of the entrepreneur and the investor is therefore important.

Another pitfall is that entrepreneurs seek new funding too late. Generally, an entrepreneur should start looking for new investors 6 to 9 months before they run out of money, as this process and transaction can take a long time. Especially in current times of high inflation and rising interest rates, this should be kept in mind.

ESG: impact on Venture Capital
The world of venture capital is currently seeing an emerging trend that focuses on Environmental, Social and Governance (ESG) factors. These are factors that take sustainability, social responsibility and good corporate governance into account. Impact investors in particular are increasingly interested in companies that pay attention to these factors. They expect such companies to perform better in the long term and have a positive impact on society and the environment. Furthermore, complying with ESG criteria can result in a better image and reputation, which can lead to more trust from customers and investors.

It is important to realise that ESG factors only come into play in the growth or expansion phase of the business. This is because in the seed and startup phase, entrepreneurs are mainly developing and setting up their service or product. Nevertheless, both entrepreneurs and investors would do well to steer towards early standardisation and implementation of ESG factors in business operations. This is easier to build from the ground up than when the company is already fully operational. For investors, such standardisation can be useful if they must report to local regulators in this area.



Venture capital launching economic development

An interesting fact emerged from research by the European Investment Fund. It turns out that venture capital is a kind of flywheel for the development of future startups. When a startup has gone through all the growth stages and the entrepreneurs have benefited financially from the value growth of their company, it turns out that some of those entrepreneurs start new startups again or invest in startups themselves. This enables exponential growth across the (startup) ecosystem and makes venture capital more commonplace.

How BUREN can help you with Venture Capital

At BUREN, we are aware of the challenges involved in venture capital investments. That is why we have a team of experienced lawyers, tax lawyers and notaries who can help you navigate the legal and financial aspects of venture capital. We can assist you in drafting investment documents, such as shareholder agreements and convertible loan agreements. We can also advise you on the structure of your company, ESG criteria and on the interests of both the entrepreneur and the investor.

Concluding

Venture capital is an important means for startups to finance their growth. It is important that entrepreneurs and investors are aware of the different growth stages, investment and financing types and pitfalls in venture capital. At BUREN, we are ready to make your venture capital journey a success. Feel free to contact me or one of my colleagues.

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