MISSISSIPPI DEFENSE DIVERSIFICATION INITIATIVE

Introduction to Diversification Financing

Introduction

Most businesses need access to outside debt financing, equity investments, grants, and incentives to properly diversify. Our program is designed to help facilitate connections to the financial resources that your business needs to grow and serve diverse client bases.

Prior to making these connections, though, it is important to learn about the various stages of business growth cycles and more about financing mechanisms to support Mississippi business diversification activities.

This *Introduction to Diversification Financing* is designed to meet these goals and help set you on the path to diversification of your business or to supporting diversification of other businesses.

Business Growth Stages

Businesses differ in size and capacity for growth, but many of them share common challenges as they grow and develop. Understanding where a business lies on the growth spectrum can help determine the best resources needed to support these challenges.

The descriptions of the following stages of emerging company development are not linear in nature, and in many cases may overlap. In some instances, the company may have achieved attributes of higher or lower stage development which are outweighed by other factors governing stage development.

Development Stage

The Developmental Stage is the beginning of the business life cycle. During this stage, also referred to as the Seed Stage, the product or service is merely an idea/concept. The company may have just been formed or have limited operating history - usually less than one year from inception. The company has no source of funding other than the owner's sweat equity and funding from family and friends, which has provided the necessary start-up or "seed" capital. The company has generated virtually no revenue as the effort has been toward product development, development of software, or refinement of an existing service offering. Without adequate funding for management and employees, stock options are viewed as the currency to attract talent. Usually, at this stage, management is wrestling to formulate its business model and growth strategy. Entrepreneurs are seeking advisors, feedback, and are performing market research in order to turn their idea into a tangible product or service.

Common Challenges they face:

- **INITIAL MARKET VALIDATION & TRACTION**
- **RAISING FUNDING**
- **NO CASH FLOW**
- **LIMITED OPERATING HISTORY**
- **INCOMPLETE MANAGEMENT TEAM**

Start-up Stage

This is still an extremely early stage of enterprise formation, as there is little capital, few employees, and the need for continued development. At this stage, the company has yet to develop external product/service revenue, but may have begun to develop proprietary processes, technology, brand or services. The company has started to incur expenses and develop projections tied to both the achievement of future milestones and to a rapid and defined growth strategy. However, uncertainty may continue to exist in regards to the sustainability of the business model. The management team is incomplete, and in most cases, without a dedicated Chief Financial Officer. At this stage, the company will begin developing presentations suitable to attract investors to fund further product development, often with the assistance of outsourced accounting/finance. At this stage, capital will typically be provided by angel funding sources.

As investors contribute funds to the company, the company is able to build prototypes, gain more knowledge about specific markets, and start testing those markets. The company in turn develops a "proof of concept," or evidence that the products are going to succeed. As the company continues to learn more about the product in the market, they are able to adapt and build a targeted customer base, as well as identify additional management members. Revenues, if any, have been generated from potential customer sources at below market rates under a "freemium" model. Company Management has taken steps to develop strategic alliances with recognized industry participants in order to establish credibility or access to resources. Key employees, including sales/marketing personnel, have been attracted through the grant of options. A focused strategic plan and investor presentations to support venture capital funding have been developed.

Common Challenges they face:

- **ESTABLISHING CUSTOMER BASE**
- **FINANCIAL MANAGEMENT**
- **UNDERGOING PRODUCT DEVELOPMENT**
- **RAISING FUNDING**

Growth Stage

At the Growth Stage, the company has developed a revenue base and organizational structure which is positioned for sustained growth. This is when profit, success, and revenue all look promising and growth is expected. Revenues are generated from a developing, targeted customer base, although robust operating profitability may have not yet been achieved due to ongoing development costs or marketing expenses through the growth stage

The initial rounds of capital have been raised in the previous stages, which leads to more sophisticated sources of funding for this stage. The biggest challenge for businesses in this stage is the scaling of infrastructure, talent, and customers. Entrepreneurs need to be able to harness the resources available to them and have a strategic outlook that enables them to plan for the future. Key attributes of a high preforming growth company include insights into key performance metrics, ability to hire and retain top talent, and ability to maintain an entrepreneurial culture.

Venture capital funding is sought to provide sources of capital. The management team may include a Chief Financial Officer and financial statements are routinely prepared and evaluated. At this stage, the founders may have relinquished control to an experienced industry management team. Projections for product/service buildout have been prepared for possible venture capital financing.

Common Challenges they face:

- **HIRING AND RETAINING TALENT**
- **IMPLEMENTING PROCESSES**
- **CUSTOMER ACQUISITION AND RETENTION**
- **MONETIZING CUSTOMERS**
- **BUSINESS INFRASTRUCTURE**
- **RAISING FUNDING**
- **OPERATING LOSSES**

Expansion Stage

The **Expansion Stage** is a period of growth into new markets, channels, segments, and/or human capital. The company has reached a demonstrated revenue base and has achieved operating profitability. Distribution channels and a recurring customer model have been established. The company's niche and position in the market has been identified and established. The management team has been assembled and is supported by a board or directors or advisors. Motivating and retaining its human capital have become key operational issues.

Expansion is a choice. While making this decision, companies often determine that more funding is needed to expand the company: inventory, capital, product development, sales, and more. This stage is one of the later stages of a company's life cycle, when several rounds of capital have previously been raised. Because the business is growing and expanding their products into new markets and distribution channels, the growth that occurs is rapid and requires funding beyond the company's internal capabilities to generate cash. Based on the company's performance and prospects, private equity, mezzanine and commercial bank financing is available to fund anticipated growth and future expansion.

Common Challenges they face:

- **HIRING AND RETAINING TALENT**
- **CUSTOMER ACQUISITION AND RETENTION**
- **CUSTOMER SERVICE QUALITY**
- **EXPANDING PRODUCT LINE**
- **SUCCESSION PLANNING**

Financing Mechanisms

Money is often considered the life blood of a business, and the landscape for funding can be difficult for entrepreneurs to navigate. Common sources of funding for the different stages of business include:

Seed Investments

The first form of financing for a new company typically comes from the founder of the company in the development stage. Seed capital investments are the initial funds required to start the business and to begin its development into something greater than just an idea. This includes researching the market and creating a product, among other initial steps. Later down the road, other investors like to see that the entrepreneur put in their own money and invested themselves into making the business a reality. Seed Investments are important because they allow a company to define direction and gain clarity of the steps it takes to get a product to market, as well as how to get that product launched from just a concept. This form of investment does not require giving away equity in the business to the investors.

Once the entrepreneur has invested their own money, they often turn to friends and family for additional funding. These people are the first believers in what the entrepreneur is doing, and have faith in the company's goals and future success. Investing money into the seed round poses high risk for investors, as the return on the investment is unknown. This depends on how the product/service is performing during its initial phases. These initial investors have hope that the company will be successful and profitable, and they want to invest, however, they are not given any voice in the business. In the seed round, most equity is raised by small convertible notes or common equity. Dollar amounts may vary, with investments typically at least $15,000 but typically less than $500,000.

Seed Investments

Another form of seed money is grant money. Grant money comes from organizations, the government, private trusts or individuals to help fund specific pieces of the company startup. Most frequently, no equity is given with grant funding. This money is typically not paid back to those who granted it.

The Small Business Innovation Research (SBIR) program and Small Business Technology Transfer (STTR), coordinated by the Small Business Administration across 11 federal agencies, is a common form of grant money provided as a seed investment. These programs are designed by the government for small business to engage in Federal R&D – with potential for commercialization. SBIRs are provided in two phases. Phase I provides funding to determine the commercial viability of a technology, and the funds typically do not exceed $150,000. Phase II focuses on the R&D, and the grant funds do not typically exceed $1,000,000.

For more information...

SEED VS. ANGEL: Seed is the early stage capital and typically comes from the founder or friends and family. Angel funding is derived from accredited investors.

EQUITY VS DEBT: Equity is capital from an investor in exchange for ownership. Debt must be repaid over time.

VC VS. PE: Venture Capital investments occur during earlier stages of development. Private Equity Investors invest in companies that have material revenues and profits.

PE VS. DEBT: Private Equity is an investment with the investor receiving a stake in the company in return, while a debt investment is a loan with the promise of it being paid back.

Angel Investments

Angels are one of the primary sources of funds for start-up and development phase companies, and provide the capital for an entrepreneur to accomplish key milestones that will make it attractive for a larger follow-on venture capital financing. Angel Investments come from individual accredited investors (excluding their home, of $1 million in liquid assets or more, or who has an income of $200,000 per year, or $300,000 for a married couple) who are seeking an equity investment into the company. They are sophisticated investors who not only provide capital for the company, but board roles. Angels are typically found through word of mouth and have an impressive network of connections that can be of value to the company down the road.

There are typically several Angels who invest into the company at this stage. They understand that there is a high amount of risk in this round of investment, as the return on investment is not as predictable as it may be in later rounds. Entrepreneurs may encounter Angel Groups where several angels invest together in syndication and may invest larger amounts of $500,000 or more at one time. This allows all of the Angels to receive the same terms and have the investment come together faster for the company to reach key milestones. The investment typically comes in the form of common stock, convertible notes, and/or preferred stock.

Angel Investments are vital, in that they help a company reach a point where venture capitalists are ready to get involved and provide even larger sums of capital. They provide guidance for a company and offer advice and feedback in terms of the direction of the company. They do, however, require equity in the company.

Unlike later stage venture capital and private equity funds, Angels are not restricted by fund terms, and can hold with their investment without time limitations usually associated with other investment types.

Venture Capital Investments

After the Angel round, Venture Capital Investments provide the financing for a company to continue to provide their product/service. They normally invest more than 4 million. These investments typically take the form of preferred stock.

Since Venture Capitalists (VCs) may participate for multiple rounds of financing at this stage, the company is typically not cash-flow positive at the point of investment. Both the risk level and rate of return are higher in the earlier stages of capital financing. These rounds are typically termed the Series A, Series B, and Series C. The Series A takes place earlier in this stage of the business life cycle, while Series C takes place during the later stage and after initial growth and proof of concept has occurred. In the earlier rounds, the risk is higher and there is a focus on rapid growth. As the Series C round approaches, less risk is involved, and expansion of the company is the primary focus.

Venture Capitalists typically raise investment dollars from individuals or institutional investors – fund of funds, foundations, and endowments – typically found through their large network of professionals. Each time they raise a round of capital, it is typically held in a "fund" that has particular criteria for investments to be made. After the VCs have made an exit from a company, those funds are returned to their investors. Having an exit event is key for venture funding, as that is the only way for the investor to receive a rate of a return or profit on an investment. If an investment goes past the term limit for a fund, the fund must agree to extend past that date, or force an exit event.

Growth Equity Investments

Growth Equity can be defined as later stage Venture Capital or early stage Private Equity. For an established company that may or may not be venture backed, it may be a minority investment to accelerate specific growth-related initiatives. The companies have a proven business model and have material revenue, but often times are limited in growth due to cash flow constraints. Companies are attracted to growth equity when traditional debt is not adequately available.

For investors, the risk is lower than in venture capital but higher than a majority private equity investment. The investor will normally invest as preferred equity for a period of 3-7 years. They also may bring expertise to the company in terms of network, financial expertise, or even key personnel to support the growth.

Private Equity Investments

Private Equity Investments are typically found in later stage companies. They invest in private companies and seek a minority or majority stake in the business. Often they utilize bank financing in conjunction with the investment to boost returns for the investors. The amount invested in Private Equity Investments varies based on the fund focus. During a much later stage, the amount invested may be much larger, possibly in the hundreds of millions of dollars. The total amount invested varies based upon the fund.

Similar to venture capitalists, the funds may reach out to individuals or institutional investors – fund of funds, foundations, and endowments – to create a fund for investment. Their goal is to find ways to improve the performance of a company by working directly with the company, typically for a longer investment term than in other rounds.

Debt

During the later stages of growth, there are several different types of debt investments available to the company. Made by banks and other financial institutions, the major benefit is that the owner does not give up control, but the business does take on interest expense. The length of the loan, the interest rate, liens, and terms all vary by product type, but the loan term during these investments is typically much shorter than other investment sources. Debt investments come in many different forms:

Credit Lines: Typically provided by a bank, this credit product is to fund the company between cash outlays and collections. They can be used to finance inventory, project work, or accounts receivables. They are short term in nature and typically have a timeframe associated with them in which they need to be paid in full. They often require personal guarantees and the bank takes a lien position.

Asset-Based Loans: Provided by a bank or non-bank institution, this credit product uses the company's assets as collateral. Common collateral includes: inventory, accounts receivable, machinery and equipment. They often require personal guarantees and the bank takes a lien position.

Leasing: Leasing can be accomplished through bank or non-bank financing. This credit facility allows for the financing of equipment to lessen the cost upfront for the company. While the company will pay more for the equipment over time, it provides flexibility in their business.

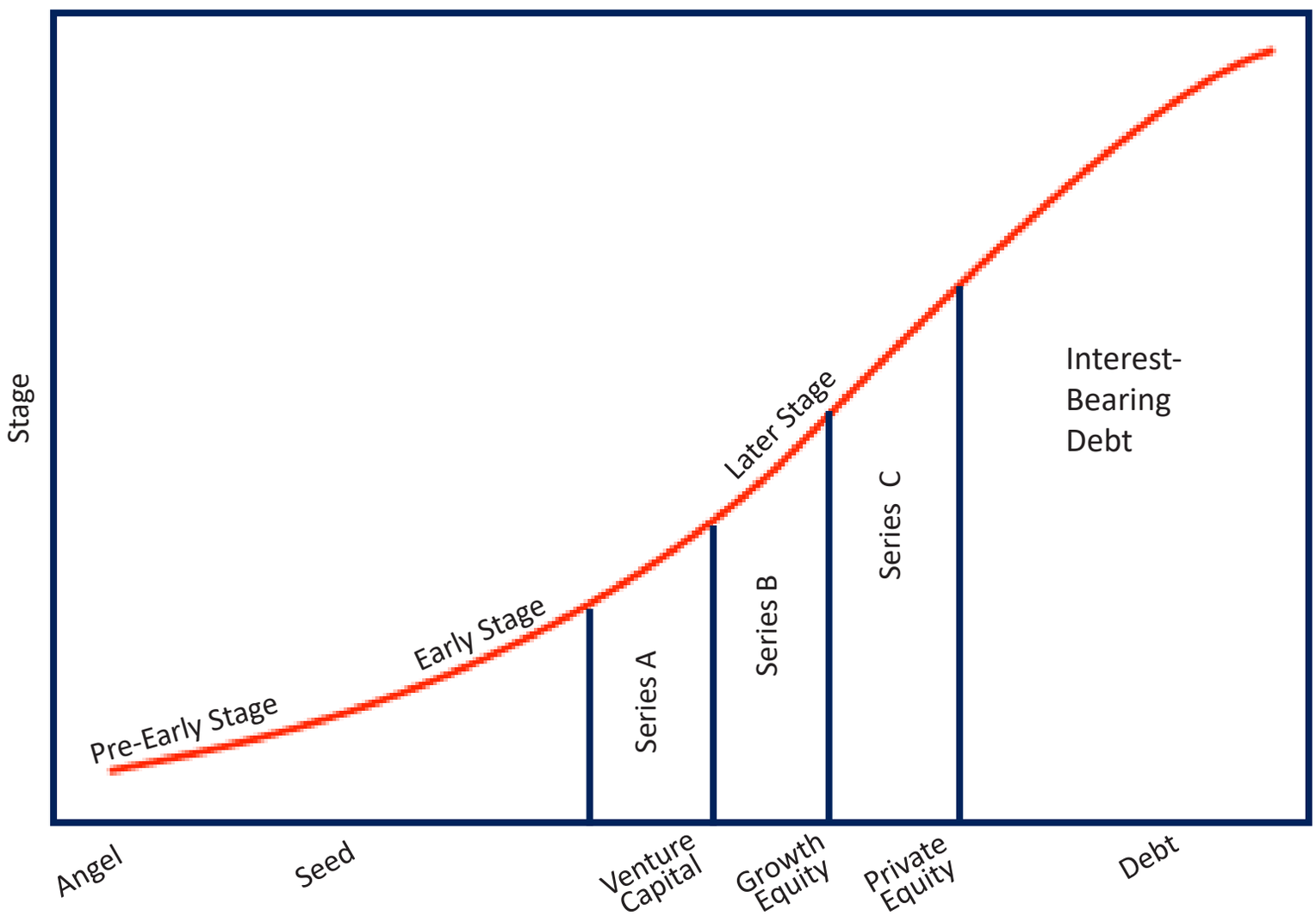
Term Loans: These are loans that are used for a variety of working capital needs, including new equipment, business expansion, purchase of real estate, and refinancing of other debt. These loans are paid off from the earnings of the company and require collateral.

Mezzanine: Mezzanine financing is used after senior debt (credit lines, term loans etc.) is in place to fund further growth of a company, management buy-outs, and acquisitions. Typically this would be seen to fund a new product line, buy out the management, or an acquisition. While the lender has the opportunity to take an equity stake if the company defaults, their goal is to gain a stated return on the investment. One advantage to the company that mezzanine financing provides is that the funds are a source of capital without losing equity. It also provides flexibility for the company in the terms of the financing through each source, and does not constrict cash flows.

Financing Mechanisms Summary

Financing Mechanism	Stage of Life Cycle	Who are the Investors?	What are they looking for?	Risk/Return on Investment	Forms of Investment / Amount
Seed	Pre-Early	Self, Founders, Family, Friends	---	High Risk	Common Stock Convertible Note $15,000-$500,000
Angel	Early	Successful Individuals, Past Entrepreneurs	Company has put own $ into company; Looking to invest smaller $; Bring company to a point where VC can now invest	High Risk / High Return at slower rate	Stock or Convertible Notes $500,000-$700,000
Venture Capital	Early – Later (Series A, B, C)	Corporations, Incubators, Accelerators	Invest larger amounts with more people involved, development & expansion	High Risk / High Return at a faster rate	Preferred Stock $4 million+
Growth Equity/ Private Equity	Growth	Private Companies, Several Individuals	Invest larger amounts, expansion or acquisitions.	Lower Risk	Preferred Stock Mezzanine $5-$100,000's of millions
Debt	Later	Banks, Other Financial Institutions	Expansion rounds, rounds in between investments.	Low Risk	Loans, Mezzanine, Bridge $2M+

Cycle of Financing Summary



Type of Investment Mechanisms

Appendix: Glossary

Accredited Investor: Under the Securities Act of 1933, individuals of high net worth (Income greater than $200,000 a year or $300,000 if married, in each of the prior two years; had a net worth over $1million (excluding the value of the primary home) and are seeking an equity investment into a company.

Accredited Investor Questionnaire: The SEC requires that companies take "reasonable steps" to verify purchases of equity are by accredited investors. The questionnaire provides a format to obtain an attestation from the investor that they meet the standards.

Anti-Dilution Rights: Provision in a security that protects an investor from dilution resulting from later issues of stock at a lower price than the investor originally paid.

Board of Directors: Elected individuals who have a fiduciary responsibility for a corporation, including hiring and firing of executives, responsibility for the financial well-being of the company, stock issuance, and the overall company strategic direction.

Bridge Loan: A short term loan that fills a gap before a company can obtain larger financing. Can sometimes be considered convertible debt if it can convert to equity when the financing is fulfilled.

Bootstrapped: Funding provided solely by an entrepreneur or through revenues of the company.

Burn Rate: Typically used in conjunction with companies that have a negative cash flow, it is the amount of money a company spends net or revenues and is typically referenced in the form of a burn rate per month.

Capital Call: The legal right whereby a fund requests previously pledged capital in order to execute an investment. Contributions typically need to be sent in within a previously agreed period of time.

Capital Expenditures (CapEx): Funds used to purchase physical assets that are long-tem in nature. Examples include computers, machinery, and property.

Capitalization Table: A document that shows the ownership of the company, classes of stock, and the price paid, per the securities.

Common Equity: The amount of all common shareholders including common stock, retained earnings, and additional paid-in capital. It does not include preferred shareholders. It typically has fewer rights than preferred equity.

Common Stock: Class of ownership of stock that has last right to assets in a company if it were liquidated. Typically, holders have voting rights and often receive dividends or capital appreciation.

Convertible Note (Debt): Short term debt financing that converts to equity at a later date. Typically used before a future funding round to delay placing a valuation on the company.

Dividends: Distribution of a company's earnings to a class of shareholders; typically a percentage.

Drag-along rights: This right is to the benefit of the majority shareholder and allows them to force a minority shareholder to join in the sale of the company.

Down-Round: When the valuation of a company is less than what it was in a prior round.

Dry Powder: The amount of funding held by investors for additional investments into the company.

EBITDA: Earnings before interest, taxes, depreciation, and amortization.

Executive Summary: A one page summary of the company that describes what the company does, the solution it provides, the capital the company is seeking, and the uses of funds.

Freemium: Strategy whereby the product (typically software) is given away for free and users are charged for upgrades or add-ons. The benefit is to attract users and upsell them to become a paid user.

Hockey Stick: Describes the growth or projection of growth whereby the revenue growth sharply increases over time to resemble a hockey stick in a chart.

Lead Investor: The lead investor who sets the terms in a syndicated round of financing.

Leveraged Buy-Out (LBO): The purchase of a company through a combination of equity and debt. The purchaser uses the company's assets to pay back the borrowed debt.

Liquidation Preference: In the event of liquidation of a company, this component of the stock agreement specifies which preferred shares get paid first, and how much they are paid. It protects investors and allows them to be repaid prior to the holders of common stock.

Mezzanine Financing: Capital that falls between senior debt and equity. It is more expensive than bank debt but less expensive than equity. The debt structure allows the lender to convert the obligation to ownership or equity in the company if the debt were to default. The debt is senior to equity and carries both a coupon and warrants typically.

Non-Disclosure Agreement (NDA): Is designed to protect parties regarding confidential information. Typically requested by the disclosing party.

Option Pool: Common stock reserved for employees as an incentive to retain key employees and recruit new employees. They are typically a percentage of the post-money shares and have an exercise price at a fair market value.

Participation Rights: Preferred stock characteristic that gives the holder the right to convert to a common stock equivalent at the shareholder's discretion upon certain events.

Platform Company: A company that receives an investment from a private equity fund with the plan to make additional acquisitions to the company. ("bolt-ons")

Portfolio Company: A company that has received an investment from a fund that their portfolio of companies.

Private Placement Memorandum (PPM): This, or a private offering document, is a legal securities disclosure document used for the sale of unregistered securities. It typically contains a summary business plan, company risks, terms of the deal, and a copy of the capitalization table. Companies should always defer to their attorney to see if a PPM is necessary for raising funds.

Pre-Money Valuation: "Pre-money" is the value of a company before it receives an outside investment, a term often used in the venture capital community.

Preferred Stock: Class of ownership that has a higher claim on earnings and assets than common stock in the event of liquidation of the company. This class often includes a dividend.

Preemptive Rights: Privilege given to shareholders that allows them the right to purchase additional shares of a company before other investors have the opportunity to partake in the offering.

Private Placement: Typically refers to any shares issued by a company in the private market and not required to be registered with the SEC.

Post-Money: The valuation of a company after an investment has been made.

Stock Option: Gives the holder the right but not the obligation to buy within a set time and at a specific price. The option can be qualified or nonqualified.

Syndicate: A group of investors that could be angel, venture capital, or private equity. Typically there is a lead investor who will take the lead in negotiating the terms of the investment for the group.

Term Sheet: An agreement that outlines the proposed specifics of an investment.

Venture Capital: Venture Capital is equity capital provided to start-up and early stage companies that have a high growth potential. Firms raise funds to maximize the potential of their company's value. The support comes in the form of additional funds, connections to market channels and management talent.

VC Backed: A company that has taken capital from venture capital is called a VC Backed Company.

Warrants: A security option that gives the right to the holder to buy a security at a certain price and quantity at a future time.

Waterfall: The order in which funds will be distributed to investors when the company is sold.

MISSISSIPPI DEFENSE DIVERSIFICATION INITIATIVE

Sponsored by:

The University of Southern Mississippi

The United States Department of Defense Office of Economic Adjustment