AUNNIE PATTON POWER

ADVENTURE FINANCE

How to Create a Funding Journey
That Blends Profit and Purpose

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I can't pinpoint when I first fell in love with finance, but it was probably sometime between my father teaching me the Fibonacci sequence at two years old (as a party trick) and my daily reports to him on share prices and company news from the Wall Street Journal in kindergarten. I may be the finance professor, but my Dad will always be my go-to finance teacher. I'm also not the first author in my family. My mother blazed the trail with her books (and now critically acclaimed podcast series) on sexuality and spirituality. In fact, I may be the least interesting writer in our family…

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Introduction

Hi there! Welcome to the world of innovative financing. If you've picked up this book, I'm guessing it's because you are looking to raise capital for your organization, or you are looking to invest capital into organizations, or maybe you're just a curious observer who wants to learn about new ways of investing in **start-ups** and **small businesses**. Well, I'm happy to report that you are in the right place.

This book is meant to take you on a funding journey, where we explore options that suit the needs of all varieties of organizations and businesses. Along the way, we stop to evaluate different types of financial structures that apply creativity and sometimes a bit of technology to allocate capital that makes sense for founders, funders and communities. We'll also delve into the tools that you need to identify and plan for your own funding and investment goals.

My hope is that your experience reading the chapters that follow will feel a little bit like that scene in the Wizard of Oz. Remember the one at the beginning where everything was in black and white, until Dorothy's house lands and she opens the door, and then everything pops out in brilliant technicolor? Right now, you may think that **venture capital** and **bank loans** and **grants** the only funding options out there. But actually, there is a whole rainbow of options that you can explore.

Why Are We Here?

As you've picked up this book, you may already be sold on why we need to take this journey together.

As a **founder**, you might be at your wits end; frustrated that you can't find funding that is appropriate for your business. Maybe you don't want to fit into the traditional venture capital model, but you don't have the right assets and track record to qualify for a bank loan. Perhaps you are building a purpose-driven business that wants to stay true to its mission, a non-profit that is seeking to build sustainable income streams or a community focused organization that doesn't want to take on external shareholders.

As a **funder**, you might also feel as if the current tools at your disposal aren't enough. You see promising founders whose visions don't fit into traditional equity, debt or grant boxes and want to find ways to help them build their businesses.

Perhaps you are a *policy maker, academic, student or advisor* who has seen the issues with early-stage funding and you are determined to find a better way to help support promising young businesses which are engines for job creation and economic growth.

I've spent over a decade helping purpose-driven companies raise capital, and I know exactly how you feel. For this book, I interviewed more than 150 founders and funders, and they expressed similar frustrations in every, single conversation.

Creative Action Network's Funding Struggle

Take, for instance, Aaron Perry Zucker and Max Slavkin of the Creative Action Network (CAN), a for-profit social enterprise built around a global community of artists and designers who make art with and for a purpose. CAN is exactly the kind of company that inspired this book. It's a purpose-driven company that wasn't a good fit for traditional venture capital but nevertheless still needed capital and supportive funders to help the business grow.

Aaron and Max were graphic designers, and also politically passionate, and in 2008 they had a brilliant idea to launch a website where anyone could upload poster art for the U.S. presidential campaign, and anyone could download and print that art for free. It was wildly successful (you know that Obama poster—yes, *that* Obama poster? That was Aaron and Max's website. It was actually originally called Design for Obama.[1]). That website was the seed for CAN.

Like many entrepreneurs, Max and Aaron thought they knew the recipe for start-up success: get into an accelerator program, raise *a lot* of venture capital funding, grow, grow, grow, and then either sell their business to a bigger company or list the company on a public stock exchange. So they

[1]Yes THAT famous Obama poster.

tried that route. They got accepted to an accelerator (Matter.Vc, a program for companies "changing media for good"). They made an **investment pitch deck**. They networked their way into the door of venture capital firms in San Francisco. But after fifty meetings and fifty "no thank you's," Max and Aaron realized that CAN wasn't a fit for those investors. **Venture capital firms** they met with were underwhelmed by CAN's potential for scale (and profits) in the **social impact** art marketplace, and they didn't understand Max and Aaron's commitment to the **social mission** of their company, which included long-term ownership of the company by the artists.

The fundraising challenges that CAN encountered are common for **social enterprises**, or even just modest-growth organizations; many mainstream venture investors simply don't understand how social impact and profitability can align.

The Eureka Moment

It wasn't until their third year **bootstrapping** CAN and building up its modest revenues that Aaron and Max discovered the world of **impact investing**, a type of finance that *does* understand that businesses can still make money while doing good—not only that they can, but that they should. CAN's founders were introduced to a venture investing firm called Purpose Ventures, where Max and Aaron first heard about a unique ownership model for companies that needed capital but wanted to stay independent and dedicated to employee ownership. This model, called **Steward Ownership**, was ideal for companies like CAN that exist to do more than maximize shareholder profit, and Purpose was ready to walk Aaron and Max through the process of structuring a deal that would provide CAN with the capital it needed while preserving its mission.

If you're reading this story and thinking, "Yes! I need to find a Purpose Ventures," or "Yes! I want to be a Purpose Ventures," great, that's exactly what most companies need and what most funders aren't. In the mainstream **venture funding** landscape, **venture capital equity funding** is synonymous with **risk capital**, and it's often presumed these days to be the only way for young companies like CAN to raise funding (outside of a traditional bank loan, which also isn't available to most businesses). The problem is traditional **venture capital equity funding** is narrow; it likes **asset-lite**, tech-enabled, **exponential growth** focused companies. Most companies don't tick those boxes.

That's why this book exists. As a founder or a funder, you should be able to chart your own funding journey—one that works for you and what you are looking to build. That's exactly what this book means to help you do, though a series of in-depth stories similar to Max and Aaron's, and a stockpile of tools, resources, and helpful frameworks. (Deal structuring nerds and textbook appendix lovers, the online companion of this book is for you.)

A Community Focused Funding Solution

Before we get started, do you want to know how Max and Aaron's funding journey with CAN and Purpose Ventures turned out? Meeting Purpose Ventures was obviously the breakthrough CAN's founders had been looking for: Purpose was an investor willing to structure financing that aligned with their vision and mission. Together, they came up with an agreement for an investment model that allowed CAN to access risk capital to grow, while enabling Max and Aaron to maintain ownership of the company in the long term by buying back investors' equityshares with the company's profits.

To be sure, bedding down the details of this model wasn't fast or simple. It took six months to get investors committed, and another six months of legal paperwork. But, in the end, this new structure enabled CAN to raise $380,000, which was $30,000 more than Max and Aaron has targeted to meet CAN's early-stage funding needs.

If spending a year negotiating terms like Max and Aaron did feel overwhelming, you should know that Max and Aaron both feel the time and effort was worth it. Here's why: "By using this model, we've been able to ensure that power stays in the hands of our artists and community, and not the investors, should the founding partners leave Creative Action Network," explains Max.

It's true that these "alternative" funding options can seem overwhelming and confusing. But fear not, we are on this journey together! Some of these instruments are widely available, others will take a bit more initiative on the part of both founders and funders. And as I mentioned, we won't just analyze the instruments in this book, we will also explore the funding process itself, to understand how it can be more inclusive and purpose driven. After all, sometimes the difficulty of venture funding isn't about the structure; it can also be that the process itself excludes promising founders.

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How to Use This Book

The material for this book comes from a decade of my own teaching and research. And because I'm not a very patient researcher, it also comes from a lot of doing (I like to call myself a "pracademic" i.e., a practical academic). You can rest assured that this isn't a textbook. Rather, it is a set of stories from founders and funders that have adapted traditional funding methods to make **venture finance** work for the 99% of businesses and non-profits that don't fit with either traditional **venture capital** or a traditional **loan** from a bank. These stories are meant to inspire you as to what is possible. Embedded within them are the tools, and a few frameworks, to help you evaluate your options and shortcut the time it takes you to create your own epic funding journey.

As my students and colleagues know, my classes and workshops generally feature a mix of founders and funders, which seems to make the otherwise somewhat dry topic of finance a little more relatable and tangible, and in turn, stimulates knowledge sharing and integrated learning. In this book, I attempt to speak to both audiences—with the default audience being founders, as your needs should be the foundation of early-stage funding options.

I have also tried to make this material as straightforward and approachable as possible, regardless of your level of financial knowledge and experience. But, if you are brand new to early-stage financing or finance in general, please use the **Glossary** (Chapter 31) as a reference throughout the book. It contains a list of definitions of all of the **bolded words** in the book, as well as additional information that should be helpful.

Founders, unfortunately, there isn't a simple formula to determine the right type of funding for each individual situation, but hopefully the information in these chapters can serve as a guide in helping you make vital decisions about the kind of financing that makes the most sense for your organization. Ideally, one of the biggest takeaways from this book will be a boost in confidence in charting your own funding journey. Having confidence in what you need and what type of funders can best support your growth can help you better identify and engage with funders that mean to be partners in your journey.

Funders, you might find that some of the definitions in the early chapters are too simplified, and so please feel free to skim over them. You might want to come back to them when you are engaging with founders, however, as I have found that there is often significant misunderstanding and miscommunication between founders and funders in negotiating financing agreements. Funders tend to assume that founders understand investment basics and thus, do not explain in simple enough language the implications of the contracts they are considering or negotiating.

Once you have digested the material from this book, you'll likely be keen to really get into the weeds of contracting. In the online companion to this book, I've built out a series of resources to help you structure, navigate and negotiate funding contracts. This material will be continually updated based on changes to accounting, tax and regulations globally.

Right! Let's get started.

Pre-reading: Your Journey Map

Before we dive into others' funding journeys, let's start by taking a moment to think through your own. What do you know (and do you need to learn) about your organization, its funding needs, and the types of funders you want to engage? Funding your business may feel a lot like staring at a completely unknown trail and choosing to… march ahead anyway. Let's make sure you have an idea of where you are starting, where you want to go, and how you want to get there, before you start shopping for gear.

Below is a list of questions that you'll want use as a self-evaluation. You'll want to keep these in mind as you are reading this book. We'll keep circling back to them; first in Chapter 4 where we'll unpack them together (*feel free to skip ahead there now, if you need more information to help you answer these questions*) and finally in Part VI, where we'll revisit these questions based on all of the journeys that we've been on together and all of the funding options that we've explored (Table 1).

Table 1 Founder's self-evaluation checklist

Who are we?	How is our company registered?
	How do we make money? Who are our customers?
	What stage company are we?
	What are our growth projections?

(continued)

Table 1 (continued)

How mission driven are we?	How embedded is our mission in our company?
	Do we have an impact track record?
What are our funding needs?	How much funding do we need?
	What do we need to spend it on?
	How do we want to pay it back?
	What are our ownership expectations in the short/medium term? Long term?
	How involved do we want our funders to be?
What type of funder is right for us?	What types of funders are there?
	What kinds of resources can they provide?
	What level of risk are they comfortable with?
	What kind of return do they require, and when?
	Who are their stakeholders? How does funding get approved?

Now that you have the questions you need to ask yourself while exploring this book, let's chart our adventure through the upcoming chapters. Each of these chapters will introduce you to a new funding option that you can consider (Fig. 1).

Several of the chapters also explore options for making the investment process itself more inclusive and mission focused (Table 2).

Alright, now you have all of the tools you need to start this adventure finance journey. Let's get going!

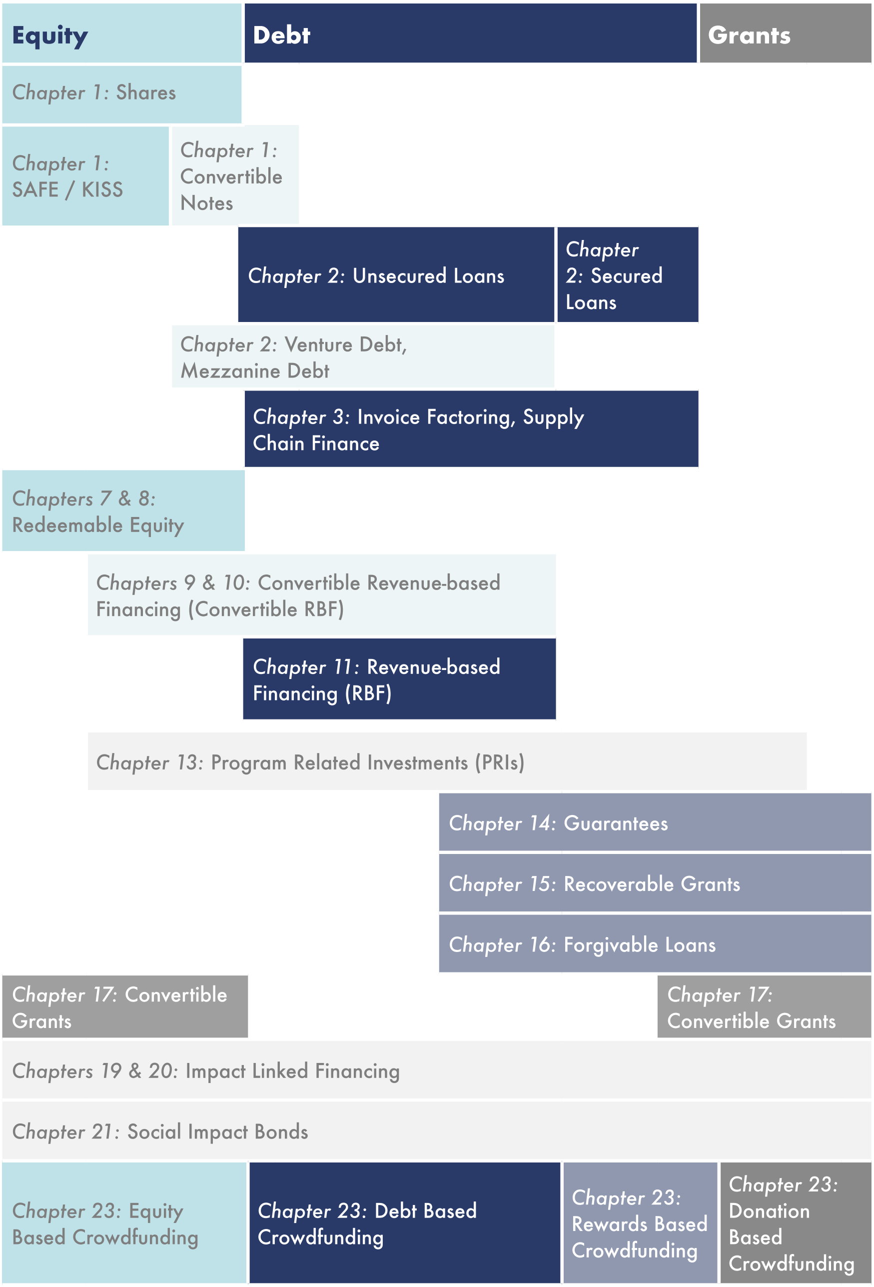

Fig. 1 Adventure finance journey map

Table 2 Investment process chapters

Chapter 23: Crowdfunding	Chapter 24: Peer-based decision making	Chapter 25: Transitioning to employee ownership

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Part I

What If: You Want to Understand Equity and Debt?

In this first part, we are going to explore the fundamentals of **debt** and **equity** financing with a bit of a twist. In Chapter 1, we will go through an equity fundraising journey alongside the founders of Helium Health. Put simply, **equity** means ownership in a company. When you raise **equity** capital, you are selling ownership in your company.

In Chapters 2 and 3, we will go on **debt** financing journeys with the founders of SOKO, Powered by People and Equal Exchange. **Debt** is when you borrow capital for your business and promise to repay this loan, generally with some amount of interest. Debt providers often require **collateral** in the form of valuable physical assets that they can seize from a company if the company defaults, i.e., stops paying the loan. **Debt** providers also look for a **credit history**, i.e., years of audited financials or a history repaying other loans. As we'll see in these chapters, there are a few innovative ways that you can structure debt without traditional collateral by using **factoring** and **supply chain financing**. We'll also look at **mezzanine** and **venture debt** options that incentivize debt providers to take the additional risk with fast-growing companies through promising them **upside** (additional return).

1

Helium Health: Our Equity Journey

Okay, here we go. Our first journey takes us to Nigeria where Dimeji Sofowora, Tito Ovia and Adegoke Olubusi founded Helium Health in 2016 based on their own experiences and frustrations with the Nigerian healthcare system. We are going to walk with them as they explore their options for raising capital by selling **equity** in their business.

As you'll see below, Helium Health is a rocketship business, i.e., they are projecting **exponential growth** and raising capital from **venture capitalists (VCs)**. Why are we starting out with their story, since I told you in the introduction that this book was for the 99% of companies that aren't projecting rocketship growth? Many of the innovative financing structures that we'll discuss throughout the book use elements of **equity financing**. So, it is important to first understand the basics of how conventional **equity** works before we get creative with it. The Helium Health story is designed to introduce all of the different **equity** options.[1]

Sensing an Opportunity

The starting point for the Helium Health journey is the fact that Nigeria's healthcare sector is in crisis. Nigeria has the seventh-largest population in the world and a healthcare system that is severely underfunded relative to its

[1]For more information on equity funding, please see Chapter 4.

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population's needs. Helium's founders Dimeji, Tito and Adegoke experienced this crisis firsthand, and in 2016, began researching the underlying issues to see where they might be able to develop a solution.

What they uncovered was a huge data problem in the Nigerian healthcare sector. Not only was the available data highly fragmented, but it was almost impossible to determine how accurate it was. Dimeji, Tito and Adegoke quickly realized that the only way to solve this problem was to start at the beginning of the data chain and track and record everything that happened from the minute a patient is admitted into the hospital right up until the minute that patient leaves.

The trio founded Helium Health as a Software-as-a-Service (SaaS) platform designed to help hospitals and clinics manage their electronic medical records. Their first step in building the company was designing and piloting an electronic medical records (EMR) system. Early on, the founders realized that digital literacy in Nigeria's healthcare sector was low. However, Nigerians are enthusiastic social media users, so Helium designed the first version of its EMR to mimic a social media experience, with a chat-like feature for notes and a simple user interface (UI). Their interface was so intuitive that when they began demonstrations with nurses, they found they could successfully train staff within a matter of days.

Helium's pilot proved so successful that by the end of its first year, the company had been awarded a prize for promising start-ups by the President of Nigeria and won the country's coveted Etisalat Prize for Innovation. Like many entrepreneurs, Dimeji, Tito and Adegoke had relied on **Friends, Family and 'Fools'** (generally called **the 3Fs**) to get their company off the ground. This very early-stage capital enabled them to build prototypes in the early days of the business.

But Helium needed some serious cash to continue building, so the founders decided it was time for the next step: raising their first round of **equity** funding. Such "pre-seed" or "seed" rounds are generally less than $1 million and are funded by **Angel Investors, Venture Capitalists (VCs) or Incubators**. Angel investors are **high net-worth individuals (HNWI)** or **Networks of HNWIs**, who put capital into fledgling businesses to help them develop intellectual property and attract customers to prove out their business model. **Venture Capitalists (VCs)** are investors who manage other people's capital through pooled funds, which they invest in early-stage businesses with the intent of making a profit. **Incubators** often offer funding alongside programs for cohorts of founders who are keen to build their businesses. **Angel investors** manage their own money, so they can often make investment decisions more quickly than other types of investors.

A Cold Email and a Warm Reception

The Helium founders started by reaching out to anyone whom they thought would be interested in investing in their business. Adegoke had seen a woman named Nichole Yembra in the news for her own fintech start-up and knew that she was interested in investing in emerging fintech companies based on her investments at Greenhouse Capital. The problem was, he didn't know her and couldn't find anyone in his network who did, so he decided he would write a "cold email" to her by trying variations of her name until he found an email address that worked. And it finally did! Nichole replied and they agreed to speak.

For Nichole, it was Helium's healthtech focus that initially attracted her to the company. She saw the value of the healthcare data that Helium was building and knew that they could monetize it down the road, as healthcare data is one of the most expensive data sets to procure.

In the midst of the conversations with Nichole, Helium's founders applied, and were accepted into, Y Combinator (YC), an American start-up accelerator famous for launching and investing in start-ups that have become billion-dollar businesses (so-called **unicorns**) such as Airbnb, Instacart and Dropbox. Nichole was keen to invest in Helium, and the acceptance into Y Combinator made the business even more attractive, so she walked the team through their options from an investment structure perspective.

Helium's first option was to sell shares in the company. These could be **common shares** or **preferred shares**. **Common shares** are also called ordinary shares and they represent ownership in a company. **Preferred shares** come with certain benefits over **common shares**, including **dividends**, which are payments made to shareholders from the profits of a company, and **liquidation preferences**, which allow **preferred shareholders** to get their money back before **common shareholders** in the event of a **sale** or a **bankruptcy**.[2]

If Helium's founders decided to sell shares in the company, they would need to negotiate with an investor until they agreed how much of the company they would sell and at what price. For instance, they would need to say that they would sell 10% of the company for $50,000. This would then provide a valuation for the company at $450,000 **pre-money** and $500,000 **post-money**. The **pre-money valuation** is the implied value of the company without the investment capital, and the **post-money valuation** is the value of the company including the investment capital.

[2]For more on preference share terms, please see the term sheet guide in the online companions.

For Helium, creating a **valuation** seemed too complex, time-consuming and costly, as they were still a very early-stage business that had not yet launched their healthcare data solution on the market. They were nervous that if they valued the company too low, they would sell too many shares at a low price and potentially lose control of decision-making within the company later on down the line.

Dye in a Bucket

Let's pause from the Helium story for a moment to talk about what selling shares in a company means for the founder. For a founder, having your ownership in a company decrease by selling a portion to investors is called **dilution**. Think of it as a bucket of water with dye in it: if you pour more water, the dye's color becomes less concentrated—it's not as strong. Each time a company raises a new round of equity capital, the founders' ownership stake gets diluted. As a founder, if you have been diluted below 50%, the other shareholders may be able to make strategic decisions on behalf of the company without your approval.

For Helium, which was still so early in getting to market, the founders wanted to raise capital while diluting their ownership as little as possible.

Introducing Convertibility

The second option Nichole presented was a **convertible debt agreement**, which is also called a **convertible note**. In this **convertible debt agreement**, Nichole would provide a loan to Helium, which would be repayable with interest, but that could be converted into shares in Helium when the company successfully raised equity capital in the future. A great advantage of this option would be that Helium's founders would not have to agree to a **valuation** for the company at this point. Nichole walked them through a hypothetical example.

If Nichole agreed to invest $50,000 in Helium in a Seed round using a convertible debt agreement, she would write her convertible debt agreement to say that the $50,000 was a loan and the interest would be 5% per year. Interest rates are common for convertible loans, though interest isn't always repaid in cash. In this structure, the interest would be "rolled up," so instead of being repaid in cash, the interest would be added to the amount of the loan over time.

Her agreement would also include a **discount rate** of 25% that would be applied if the convertible loan converted into equity. This means that Nichole would be able to buy shares at a price that is 25% cheaper than new investors—a provision that is designed to compensate Nichole for the additional risk she is taking on by investing earlier than others. Until an equity round was finalized, Nichole would not own any shares of Helium; rather, her convertible note would sit on the company's balance sheet as **debt**, just like any other type of **loan**.

With these terms, Nichole explained that one year after her initial investment, her total outstanding loan would equal \$52,500: \$50,000+ the 5% interest of \$2,500. When Helium raised its next **equity** round—a Series A round—Nichole could decide to take the \$52,500 that would be owed to her and convert the loan into equity.

In a \$500,000 Series A round at a **post-money valuation** of \$1.5M, this would mean that the new Series A investors would buy 100,000 shares at \$5 per share and Nichole would be able to purchase Helium shares at \$3.75 per share. Nichole's price would be determined based on a 25% discount to the Series A investors' cost of \$5 per share (\$5 × 75% = \$3.75).

Based on this price, she could purchase 14,000 shares with her \$52,500. Nichole would thus own 4.5% of the company, the Series A investors would then own 31.8%, and the founders would retain 63.7%. Below is an illustration of this ownership. This is called a **capitalization table** or **cap table** (Table 1.1).

Table 1.1 Illustrative capitalization table

	Seed round		Series A		
	% Ownership	Shares	% Ownership	Shares	$ invested
Helium	100	200,000	63.7	200,000	
Nichole	0		4.5	14,000	$52,500[a]
Series A			31.8	100,000	$500,000
Total	100	200,000	100	314,000	$552,500

[a]This amount represents the total cash from the Seed round (\$50,000) in the form of a convertible note + the interest that is owed (\$2,500). It doesn't represent new cash to the company in the Series A.

A Simple Agreement?

Even though a convertible debt agreement can be easy to set up, Nichole presented Helium's founders with a third option that would likely be quicker for them to use. This structure is called a **simple agreement for future equity (SAFE)**. A **SAFE** is an agreement between a founder and a funder that stipulates that the funder will invest in the business but allows the major terms of that investment to be set by the next round of equity funders. The **SAFE** was created by Y Combinator in late 2013. In the years since, it has been used by almost all Y Combinator start-ups and many others for early-stage fundraising.[3]

Let's pause again to quickly discuss how SAFEs work. When negotiating a SAFE, you really only have to negotiate two things: the **valuation cap** and **the discount rate**. The **valuation cap** is the maximum valuation at which the SAFE will convert in the next round. This limits the amount of **dilution** for the SAFE investor as it sets a maximum share price that the SAFE investor will pay for the shares. Unlike a convertible note, this does require the investor and the investee to agree on a valuation of the company.

Let's use the same numbers in the convertible note example above to illustrate a **valuation cap**. If instead of a discount of 25%, Nichole had a **post-money valuation cap** of $1,125,000. She would have also paid $3.75 per share instead of $5 per share.

The **discount rate** is how much less the **SAFE** investors would pay per share than the Series A investors. The same logic as the **convertible note** applies here, in that the **SAFE** investors have invested early into a company and taken more risk by making that early investment, so they should be able to buy the shares at a cheaper price. For **SAFEs, discount rates** can range between 10 and 70%.

Nichole told Helium's founders that from her experience, there were several advantages to a **SAFE**: simplicity, cost and a faster close. As a **SAFE** is a very short document with few terms to negotiate, it would save both Helium and Nichole money in legal fees and reduce the time spent negotiating the terms of the investment. Second, a **SAFE** can be closed as soon as both parties are ready to sign the agreement and the investor is ready to wire the money. For Helium, this would mean that they could get the money they needed right away from Nichole, without waiting for other investors to join a complete round.

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[3]The SAFE itself has evolved over time and the updated documentation is available on the Y Combinator website, including their SAFE user guide, which explains the details of the instrument from an investor and an entrepreneurs' perspective in great detail.