Give Me Equity or Give Me Debt:

Robert Porter

Making the Right Non-dilutive Financing Decision

The equity that founders and early-stage investors hold in a company represents not only a share of ownership but also a stake in its future success. As an entrepreneur, you must treat owner equity like the precious commodity it is. Maintaining a sizable portion of your company's equity is essential in keeping it aligned with your vision. Sacrificing equity means not only agreeing to split the business's financial rewards but also inviting more parties to the table and committing to incorporating their ideas in future plans. By retaining a substantial portion of equity, you secure control over your company's strategic direction. When an entrepreneur surrenders too much equity early in their company's development, they risk ceding influence over key business decisions. This can create misalignments

between the founder's plan and external investors' priorities. Whenever possible, hold onto a significant share of equity, so you can steer your company in the direction you picture, ensuring that your original ideas remain intact and your mission unwavering. Finally, keeping a healthy inventory of ownership equity in reserve keeps all your options open when seeking future funding opportunities. Not only does this leave equity positioning open to new venture capitalists, but it also demonstrates your confidence in the business's solutions and financial viability.

Non-dilutive Capital: Maximizing Growth and Preserving Equity

In most cases, equity financing rounds will be essential to a startup's success. When possible, however, non-dilutive financing (NDF) provides an attractive alternative.

Each type of NDF has its benefits and its drawbacks. You should carefully consider which options best suit your business needs and growth plans. The choice often comes down to your industry, stage of development, and specific funding requirements. Whichever flavor suits your taste, strategically leveraging NDF options can help you secure the capital you need to fuel business growth while maintaining control and ownership of your venture.

Debt Financing

Loans and credit are common methods for funding startup companies. These methods require debt repayment with interest, which can restrict cash flow, but the benefit lies in the preservation of equity.

In debt financing, a startup borrows a lump sum from a lender or obtains other assets from a creditor, agreeing to repay the principal amount, with interest, over a predetermined period. Also, most loans will be secured by company assets and viewed as higher-priority debt during a liquidation event. Additionally, most deals will include financial and performance covenants that must be met in order to stay compliant and not be considered in default.

- *Loans* — Sources include traditional business banks, the Small Business Administration, and alternative and private lenders. The interest rate and repayment terms vary based on the lender's assessment of the startup's creditworthiness and financial stability.
- *Lines of credit* — Access to funds up to a certain limit, allowing businesses to borrow as needed and repay with interest only on the amount outstanding.
- *Equipment Financing* — Manufacturers may allow startups to purchase needed machinery or equipment using a small down payment and regularly scheduled installments. Borrowers pay for the privilege, of course, as the total repayments will be higher than the sticker price. Still, equipment financing allows fledgling businesses to acquire necessary tools of the trade while keeping ownership and avoiding tying up valuable operating cash. In most cases, the purchased equipment serves as collateral, and the lender retains the right to repossess it if payments fall into arrears. At other times, especially if the creditor considers the startup venture a high-risk (or the equipment's resale value is insufficient), the lender may require the owner to sign a personal loan guarantee or put up more collateral such as additional equipment, inventory, accounts receivable, or intellectual property.

Businesses with strong credit, predictable cash flows, and the confidence to manage the repayment schedule effectively may choose debt financing. And because interest

payments on debt are often tax-deductible, depending on the stage of the company, debt financing can be an affordable way to fuel growth while preserving equity ownership.

Asset-based and Revenue-based Financing

Asset-based and revenue-based financing leverage startup resources other than equity and offer potentially attractive alternatives to taking on debt. These methods may offer startups greater flexibility by aligning repayment structures with the company's financial performance and asset value.

With asset-based financing, a startup receives a capital infusion against the value of its inventory, accounts receivable, equipment, or other assets. The lender provides funds based on a percentage of the assets' value. As the company's assets grow, so does its borrowing capacity.

Revenue-based financing, on the other hand, is tied to a company's income stream. In this model, the investor provides capital in exchange for a percentage of ongoing gross revenues.

- *Factoring* — Neither equity nor debt financing, this common form of asset-based funding involves the sale of outstanding invoices to a third party (a factor) at a discounted rate. For example, if a company has $1 million in accounts receivable on its books due over the next 90 days, it might consider selling them to a factor for $800,000. The factor delivers the cash, takes ownership of the accounts, and collects the revenue as the invoices come due. However, these agreements usually contain provisions for uncollectible accounts and any such items may need to be repaid or covered by other less risky transactions. If you are considering factoring, make sure you have accurate and complete records of all contracts and any related documents (agreements, shipping documents, product acceptance, etc.) as they may be necessary to ensure timely collections.
- *Revenue-based Loans* — Rather than selling the assets, the startup uses the revenue stream as collateral to secure a loan which will be paid along with a "multiple" that acts as interest on the advance. However, the monthly loan repayment amount varies based on the company's revenues during the period. The higher the revenue, the higher the payment and the sooner the loan is paid in full.

Startups boasting significant tangible assets may find that asset-based financing meets their objectives. It offers quick access to capital but requires careful management to avoid asset seizure risks, though the amount of accessible funding is limited to the value and availability of those assets.

Companies with strong recurring revenue streams and growth potential, however, may prefer revenue-based options for their flexible repayment terms aligned with the company's performance. This method can strain cash flow, however, especially for businesses operating on thin margins.

Grants

Entrepreneurial organizations whose products and mission align with public policy objectives or a charitable foundation's focus will find government and private party grants difficult to pass up. Startup companies researching and developing solutions to social and environmental challenges in alignment with the sponsor's requirements position themselves to obtain money that does not need to be paid back.

- *Government grants* — Offered by federal, state, and some local agencies, government grants support innovation around solving problems. These grants can significantly boost startups working on groundbreaking technologies or public-benefit projects. However, they are highly competitive and often come with stringent requirements and objectives that must be met, which can impose restrictions on strategy and how the funds are used.
- *Private grants* — Available from charitable organizations and research foundations that support specific causes or industries, these grants are usually less restrictive than government grants, making them particularly alluring for startups competing in niche areas or those with social impact missions. This greater flexibility in fund usage, however, widens eligibility, making them highly competitive as well.

Grants are a valuable funding source for startups, offering validation and enhancing credibility, which can attract additional investors. These funds often target innovation, research, and social impact, providing crucial support for specific projects. However, the application process for grants is often lengthy and resource-intensive, requiring significant effort and resources.

Tax Credits and Incentives

Credits and incentives reduce tax liabilities, freeing cash that can be allocated to a startup's essential needs.

Like government grants, these benefits are typically available to companies engaged in research and development, renewable energy, manufacturing, and other sectors that meet specific governmental criteria. Startups whose revenue has grown to a point where they owe taxes can directly benefit from these credits. However, even those not yet profitable can take advantage by selling their credits to other corporations, thus generating immediate cash flow.

To apply for tax credits and incentives, startups must meticulously document their activities and ensure compliance with specific criteria set by the government. This often involves detailed record-keeping and periodic reporting to demonstrate that the company's operations align with the requirements for the credits. The application process can be complex, and many startups seek assistance from tax professionals or consultants specializing in tax incentives to navigate it effectively.

The cash startups save on taxes can bear directly on the startup's financial health, paying for things like product development, marketing, and expanding operations and creating additional flexibility that accelerates growth and enhances competitiveness.

Selling tax credits provides a unique opportunity for startups that are not yet profitable. By transferring these credits to other companies, startups can obtain much-needed capital to fuel their growth and sustain operations while still in the early stages of development. This aspect of tax credits makes them a versatile tool in the funding mix, providing immediate benefits regardless of the startup's maturity.

Accelerators and Incubators

Accelerators and incubators offer entrepreneurs access to mentorship, insights, connections, and resources that can be crucial for early-stage companies. These programs typically provide a structured environment for startups to grow and develop over a fixed period, usually ranging from a few months to a year.

These organizations also have become vital components of the startup funding ecosystem. While some take equity stakes in the companies they support, others offer non-dilutive grants. These funding options can be preferable to other forms of non-dilutive financing, such as loans or crowdfunding, considering the additional resources involved. Participation in a reputable accelerator or incubator also lends the startup credibility that might make it easier to attract future investors or customers.

To obtain funding from these sources, entrepreneurs typically need to go through an application process, submit a business plan, pitch the idea, and demonstrate the business's growth potential and scalability. The selection process can be highly competitive, with some top-tier programs accepting less than 5% of applicants. Once accepted, entrepreneurs are expected to participate fully in the program, which may involve relocating to the accelerator's location for the duration. This immersive experience allows founders to focus entirely on growing their business while benefiting from the program's resources and network.

The intense, fast-paced nature of these programs can be overwhelming for some entrepreneurs. In addition, the equity stake required by some accelerators might not be worth the funding and support provided, especially if the startup is already showing robust growth potential and the standardized approach of some programs may not suit all business models or industries.

Corporate Sponsorships and Partnerships

Relationships with corporate stakeholders and executive leadership can result in financial support for startups in addition to priceless strategic guidance and market access. Entrepreneurs should work to identify potential corporate partners whose strategic goals align with their offerings or technology. Armed with an understanding of the target companies' business objectives, pain points, and innovation strategies, founders can knowledgeably approach them at networking events, industry conferences, and through introductions from mutual connections.

Be prepared to converse confidently about your company, articulating a clear value proposition that demonstrates how a partnership can benefit the corporation. Showcase your startup's technology and how it applies to a specific challenge the corporation faces or demonstrate a co-branding opportunity that could enhance the corporation's market position.

An association with a well-established brand can lend credibility to any startup, opening doors to new customers and investors. Be aware, however, that some corporations will expect exclusivity agreements that limit the startup's ability to work with other companies in the same industry or other concessions (such as pressure to adapt the startup's product or service to meet the partner's specific needs) potentially diverting focus from the startup's original vision.

To include corporate sponsorships and partnerships in a non-dilutive financial plan, startups should first clearly define their funding needs and partnership objectives. This might involve creating a tiered sponsorship structure with distinct levels of benefits corresponding to various levels of support. Startups should also consider offering pilot programs or proof-of-concept projects as a way to demonstrate value and build trust before seeking larger commitments.

It’s crucial to establish clear agreements that outline the terms of the partnership, including funding amounts, resource allocation, intellectual property rights, and any performance expectations. These agreements should also include provisions for regular review and potential exit strategies to ensure the partnership remains mutually beneficial over time.

Conclusion

Balancing the need for capital with the goal of equity retention is a critical aspect of strategic decision-making for any entrepreneur. Equity is essential for founders to maintain control over their company’s strategic direction and vision. As a founder, giving up too much equity can dilute your influence and potentially lead to misalignments with investors’ goals. By preserving equity, you ensure that your vision remains intact and you remain at the helm, steering it toward long-term success.

When you hold onto your equity, you can make decisions that prioritize the company’s health and growth over the long term rather than focusing on short-term gains to satisfy external investors. This approach fosters a sustainable business model that can adapt and thrive in changing market conditions.

The strategic decision to pursue non-dilutive financing is a critical one for entrepreneurs. By leveraging non-dilutive financing options, such as grants, revenue-based financing, debt financing, and strategic partnerships, you can secure the capital you need to fuel growth without sacrificing autonomy. This balanced approach empowers you to achieve your business goals while maintaining control.