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Startup Funding: Introduction to Friends and Family, and Angel Investors

Article #5 of Hopping on the Brewery Bandwagon Series

You've finally decided to quit your job to open a brewery or brew pub. Now the reality sinks in and you need to raise money to turn your dream into a reality. Before heading down the path of "venture capital," a lot of emerging companies first go to friends and family, as well as angel investors. Below is a guide on what to expect when raising these types of funds, ideas on how to use the funds most effectively and common pitfalls to avoid.

Friends and Family

Who: These are friends, relatives, acquaintances of these people, neighbors, former professors, college roommates and others. They may or may not have startup experience or business acumen at all.

What to Expect: These individuals will be very excited and your conversations with them will sound very promising. A lot of these individuals will not invest. If they do, their investments may be in smaller amounts than what you anticipated. At the same time, things move quickly—friends and family generally do not require the extensive financial due diligence in the start-up.

Word to the Wise: Consider structuring the friends and family round through convertible notes with a 5%-15% "sweetener." The sweetener can be structured as a warrant or as a conversion discount on the note. What this means is that if your parents invest $30,000, it comes in to the startup as a note; you parents are not owners yet. The note has low interest and no annual payments for several years. Upon raising a subsequent amount of funding from angels or venture capitalists (VCs), the note converts to equity (this is considered a "Qualified Financing"). Your parents would be issued the same equity issued in the Qualified Financing and at the same valuation. Additionally, for investing early when the risk is high, your parents also receive an additional 5%-15% common stock/unit as a sweetener.

Properly value the startup when taking in money from friends and family. An unreasonably high valuation in the friends and family round may seriously impact your ability to raise money from angels (and VCs down the road). For example, if you raise $100,000 from friends and family in exchange for 1% of the startup, the

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post-money valuation is $10 million. Down the road, an angel investor may be prepared to invest $500,000, but only at a pre-money value of $1.5 million (angel expects 25% of the startup for its investment). A few things can happen: (1) if you're unwilling to adjust from the $10 million valuation, the angel likely walks; (2) if you accept the angel money and leave the friends and family investors as-is, they have a huge loss of value on their investment; or (3) if you accept the angel money and adjust the valuation retroactively, your percentage ownership as a founder is reduced so the value of the friends and family investments remain intact. Convertible notes with a sweetener solve these problems.

Angel Investors

Who: These are high net worth individuals generally found within the same community as the startup company. They are often former entrepreneurs, but not necessarily within the same industry as the startup company. They typically have decades of experience investing in startup companies, have strong networks within the community and often invest with other fellow angels.

What to Expect: These investors will provide you cash in exchange for an equity interest in your company. They will expect to see an official business plan, financial projections and statement (if any), along with a private placement memorandum ("PPM"). At a very high level, the PPM will outline your valuation in the startup, the amount of money you expect to raise, how the money will be used and the type of equity you are offering.

Word to the Wise: Make sure your financial projections are realistic. Despite all the time you spend preparing the executive summary and business plan, it often comes down to the numbers. Overly optimistic projections tell these sophisticated investors that you may not understand the financial side of your business and may cause an investor to walk away.

Think of realistic exit strategies for angel investors. When making the pitch to angels, explain how they will make money, generally within a seven year time frame.

If you have questions about the topics covered in this e-alert, please contact your Reinhart attorney or any member of the firm's Food and Beverage team.

Stay tuned for the series' next article on additional financing options, including crowdfunding.

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