EARLY-STAGE CAPITAL RAISING FOR CANADIAN TECHNOLOGY COMPANIES

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Raising capital to get your business off the ground is one of the biggest hurdles you'll face on your entrepreneurial journey as an early-stage technology company. As self-financing is often not feasible for early-stage technology companies (which may be capital intensive in the early stages), companies frequently pursue external investors to grow the business. This bulletin provides an overview of the stages and types of financing common for early-stage Canadian technology companies.

Understanding Equity Financing

Equity financing for early-stage companies typically occur in stages or series as capital needs of the company expand and certain benchmarks are achieved. These stages of financings are denoted as seed financing, followed by series A, B, C and, sometimes, D financings. At the seed stage, it's common for founders to evaluate accelerators and incubators such as Highline Beta, YC or TechStars, as these programs provide support, in-kind mentoring and services, in addition to investment. Equity investment with reputable accelerators is often non-negotiable, and it's important to understand the structure of these investments in advance and how these entities will fit into your cap table.

Pricing equity shares in seed and series A rounds is particularly challenging from both a company and investor perspective. First, serious thought must be given to the sweat equity of the founders (where contributions are in in hours and ideas; not dollars and cents) and the percentage of the company to which they should be entitled for their contributions (including risks assumed). Second, valuations of early-stage growth companies are often highly speculative as early-stage businesses may still be in the R&D stage, or if there is a product, the company may have limited or no sales. Third, forecasting future growth is highly subjective and reasonable people (founders and investors) can differ significantly on such forecasts. Accordingly, pricing of seed and series shares is often the most significant point of negotiation between companies and potential investors at this stage. Any term sheet you get should be treated as a negotiation.

Founders should be extremely purposeful about the number of shareholders investing at this early stage. While raising capital with a low number of large investors is desirable from an ease of capital raising

perspective and such investors are more likely to provide equity support in subsequent rounds, large cheque investors are not easy to find (especially for early-stage companies). If early-stage companies raise large amounts of capital from a few investors, these shareholders may negotiate for board representation, and in any event are able to exert considerable influence over management decisions. Such influence may steer the company in a direction the founders are uncomfortable with.

In contrast, raising smaller amounts of capital from a greater number of investors, may limit the loss of founder control; however, this creates a larger shareholder basis which can be challenging to manage administratively and may later make the company less desirable as an investment to potential venture capital and other institutional investors who may view this capital structure as unwieldy. A large number of shareholders can also affect the speed with which major corporate transactions can be undertaken, in instances where shareholder approvals are required or where a shareholder agreement is adopted. There are also securities law implications with the loss of “private issuer” status (when the number of shareholders exceeds 50) which leads to enhanced compliance obligations and associated costs.

While many early-stage companies desire multiple classes of shares to reflect different rights and privileges for different founders and early-stage investors, generally, share capital structure should be as simple as possible, ideally with two classes of shares, common and preferred. Overly complicated capital tables with multiples classes and series of shares are viewed as unattractive by venture capital investors, who may ultimately require that the company simplify its capital structure in connection with any investment.

Equity Financing Rounds

Startup financings for Canadian tech companies typically consist of an initial seed round and each subsequent qualified financing after seed is typically assigned a letter per round, A, B, C, and if necessary, D. In a company’s growth journey, we typically see the size and pricing of each round increase (unless you’re doing a down round, something we will discuss in future bulletins).

Seed financing is typically sourced from founders’ themselves and from their families, friends and business associates. In addition, wealthy individual investors in your local tech ecosystem or “angel investors” may invest in seed rounds. Seed round financing is used to start an early-stage business, often at a conceptual research and development stage. Venture capital firms may sometimes participate in seed financing rounds.

Series A financings are for early-stage companies that have advanced past the conceptual stage and have a product requiring capital for marketing, sales and product development. At this stage companies may have a working prototype and early customer traction. Venture capital firms often commence funding companies at Series A and angels also continue to invest at this stage. Venture capital firms will often seek investment via preferred shares as opposed to common shares. Preferred shares provide holders any combination of

preferential rights over holders of common shares, the most common being a liquidation preference to be paid first in the event of a company dissolving due to going out of business or being sold for less than anticipated thereby decreasing the investment risk for the venture capital firm.

Series B financing is used to continue to develop a business through sales and marketing and growing the team beyond core personnel.

Series C financing is typically used to scale the business by any combination of expansion into new geographic areas, products or acquisitive growth (acquiring competitors or complementary businesses). Depending on the company's targeted exit or "liquidity" event (such as a merger, being acquired or going public), various financiers including private equity firms and investment banks will invest in Series C financing.

Series D financing, although less common, occurs when a company requires additional capital than raised in past rounds to accomplish its business goals.

The venture capital industry (in Canada, the Canadian Venture Capital Association, or "CVCA") has standardized investment documents and companies departing from these forms of industry accepted documents risk alienating venture capital firms. It is best practice to seek a law firm that familiar with these documents and is able to efficiently negotiate key terms on your behalf.

SAFEs

Prior to establishing a company's value (often during the seed and Series rounds) many companies may use Simple Agreements for Future Equity or "SAFEs", investment contracts allowing investors to convert their investment in a company into equity shares upon the occurrence of a triggering event. SAFEs allow companies to obtain financing expediently as the forms of agreements are simple and contain relatively few terms thereby decreasing the need for negotiation between parties. For a detailed overview of SAFEs, refer to our article "Practical Considerations of SAFEs in Canada". Companies may also raise capital with convertible notes which are similar to SAFEs as they are convertible into equity, but are debt, bear interest and have a specified term.

How to Market a Capital Raise Without Going Offside Securities Laws

One of the most challenging aspects of capital raising, especially for early-stage companies, is *finding* investors. When marketing a capital raise and seeking investment, founders need to consider who you can target (not everyone you meet is qualified under securities law to invest) and how you can market to investors (contrary to popular believe and practice you can't broadly market a financing via social media even if it's informal crowdfunding).

Early-stage companies are typically able to raise capital from the following persons: (a) directors, officers, and

employees of the company; (b) family, friends and business associates (companies have to be very careful here, as qualifying as a "family" or a "friend" of company requires satisfying certain criteria under Canadian securities laws not immediately obvious and abuse of this capital raising mechanism may attract regulatory scrutiny); and (c) "accredited investors" (investors with significant financial resources). Other types of investors may be permitted under securities laws; however, it is important to obtain legal advice if you are unsure.

When marketing a capital raise to potential investors, management must be very careful to ensure they are not engaging in activities deemed by Canadian securities regulators to be "in the business of trading" requiring the company to either register as a securities dealer or exempt market dealer (time consuming and costly) or retain an existing dealer (expensive; commission must be paid and typically dealers won't raise capital on behalf of early stage companies) to sell on behalf of the company. Canadian securities regulators recognize early-stage companies frequently raise capital and if these activities are for the purpose of advancing the company's business plan, this alone will not require registration. Nonetheless, these companies must ensure when capital raising, they do not employ or contract individuals to raise capital on behalf of the company if those individuals are not properly registered or portray the company itself as being in the business of selling securities. In addition, employees should not take compensation for selling securities and the company must ensure the company's business or a portion thereof is not marketing or selling securities of the company.

Companies may consider raising capital through one of the growing numbers of Canadian online platforms, however they should ensure the platform is properly registered as an exempt market dealer, otherwise founders run the risk they are raising capital on an improperly registered platform. This could result in regulatory scrutiny, including sanctions to the platform.

Grants

Grants allow companies to secure financing without relinquishing ownership like in an equity raise or incurring interest obligations like in a debt obligation. To maximize grant opportunities, companies should have grant applications prepared before a program opens as applications are time consuming and grants fill up quickly.

When applying for grants, companies should prioritize those that align with their strategic and long-term business plans and must in certain circumstances be willing to alter aspects of their business to satisfy grant criteria. Grants typically fund specific activities and not operational costs. Additionally, companies should, to the extent able, maintain healthy cash flow as grants are often not provided upfront but are reimbursed after expenditures are made.

Understanding Debt

Debt is a liability of a company and can be unsecured or secured against the assets of a company. Debt offers a

means for companies to raise funds without ceding control of its business by giving up equity. In addition, interest accrued on debt is generally tax deductible. However, debt must be repaid, and it exposes the company's property and assets in the event the company is unable to repay it.

In the very early stages, emerging companies typically encounter challenges securing loans from institutional lenders, especially if they lack tangible assets for collateral. Even when a loan can be secured, they often are accompanied with high interest rates, which reflects the risk profile of the loan. Accordingly, early-stage companies are often unable to access high quality debt until later in their lifecycle.

If you have any questions regarding raising capital for your early-stage company, please contact one of the authors of this article.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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