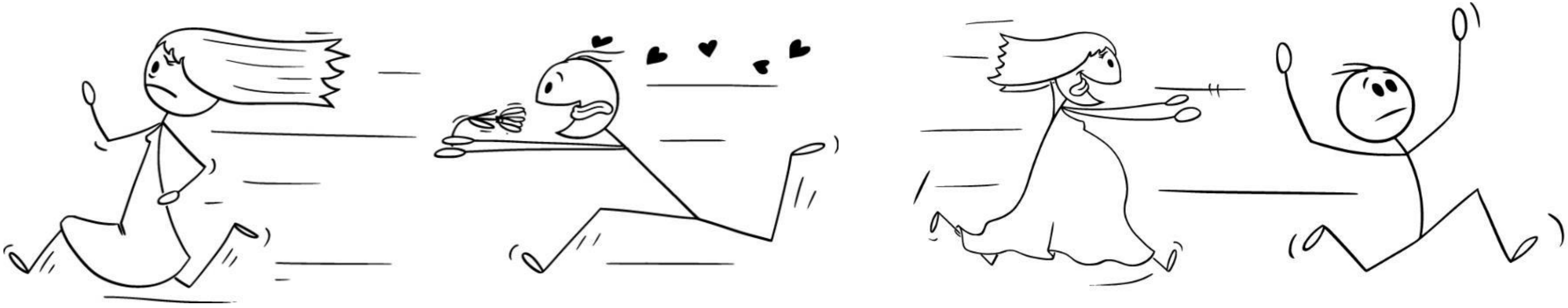
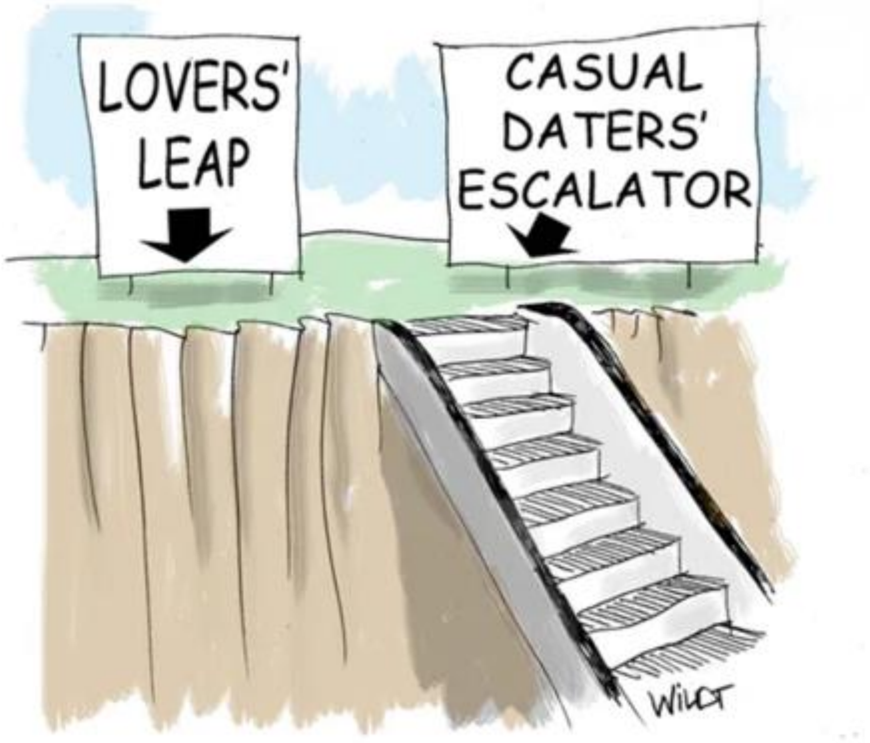
Business Financing Explained According to Lessons from Everyday Life*



Observation: We All Know No Human Relationship Is Without Risk….

Yet very few people choose to go through life all alone



It's the same with business financing…

What Are the Different Business Financing Options?

Most like on again, off again dating

Debt

Most like marriage somewhere where divorce is almost impossible

Equity

Most like dating multiple people at once

Reseller relationships

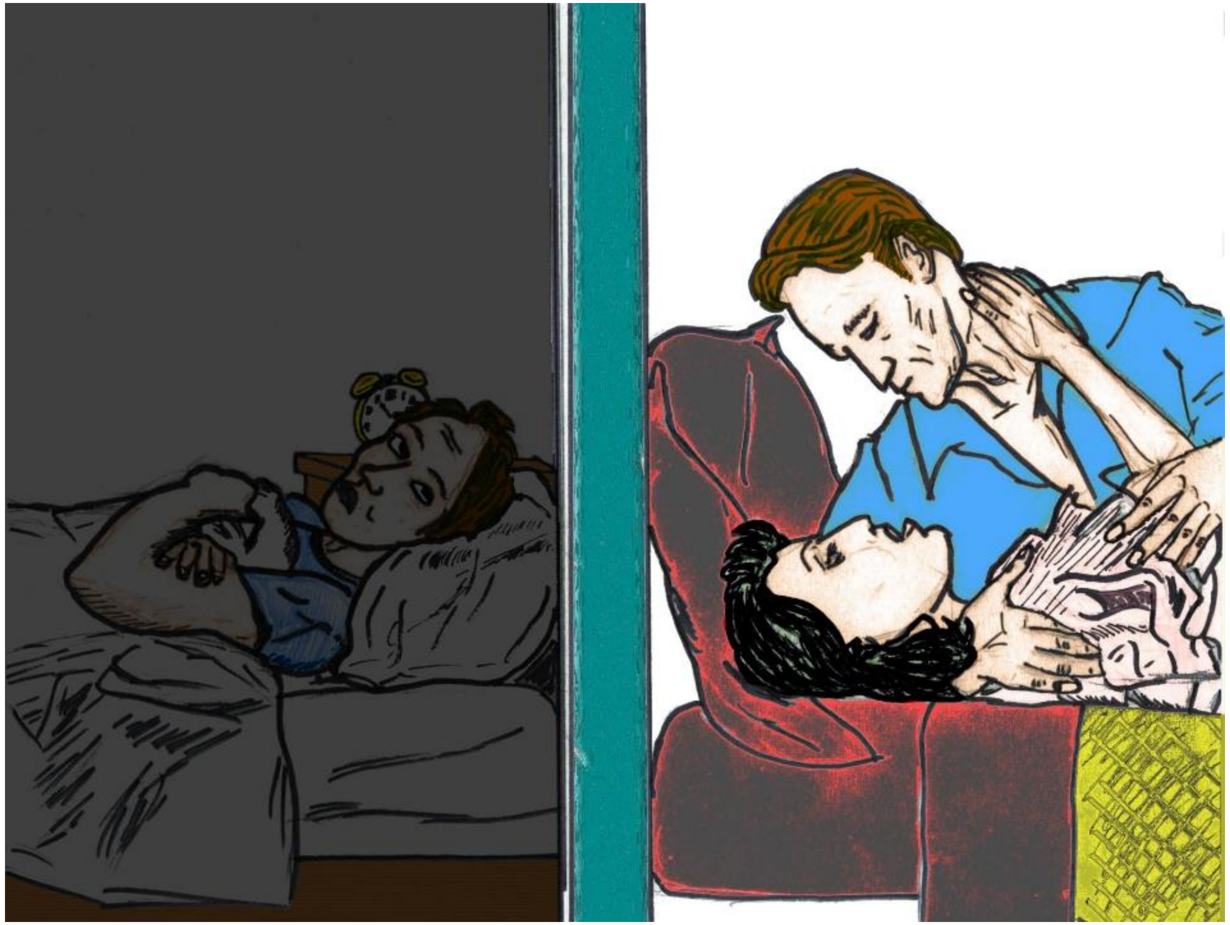
Any combination of these

Business Financing & Romantic Relationships Have a Lot in Common

For a lasting relationship, there needs to be "chemistry" – or at least genuine belief, and ultimately a shared set of values

But even for quick, no-future-obligation transactions, there must be enough attraction / motivation on both sides for it to go anywhere

Being Alone Is Okay… Until It Really Isn't

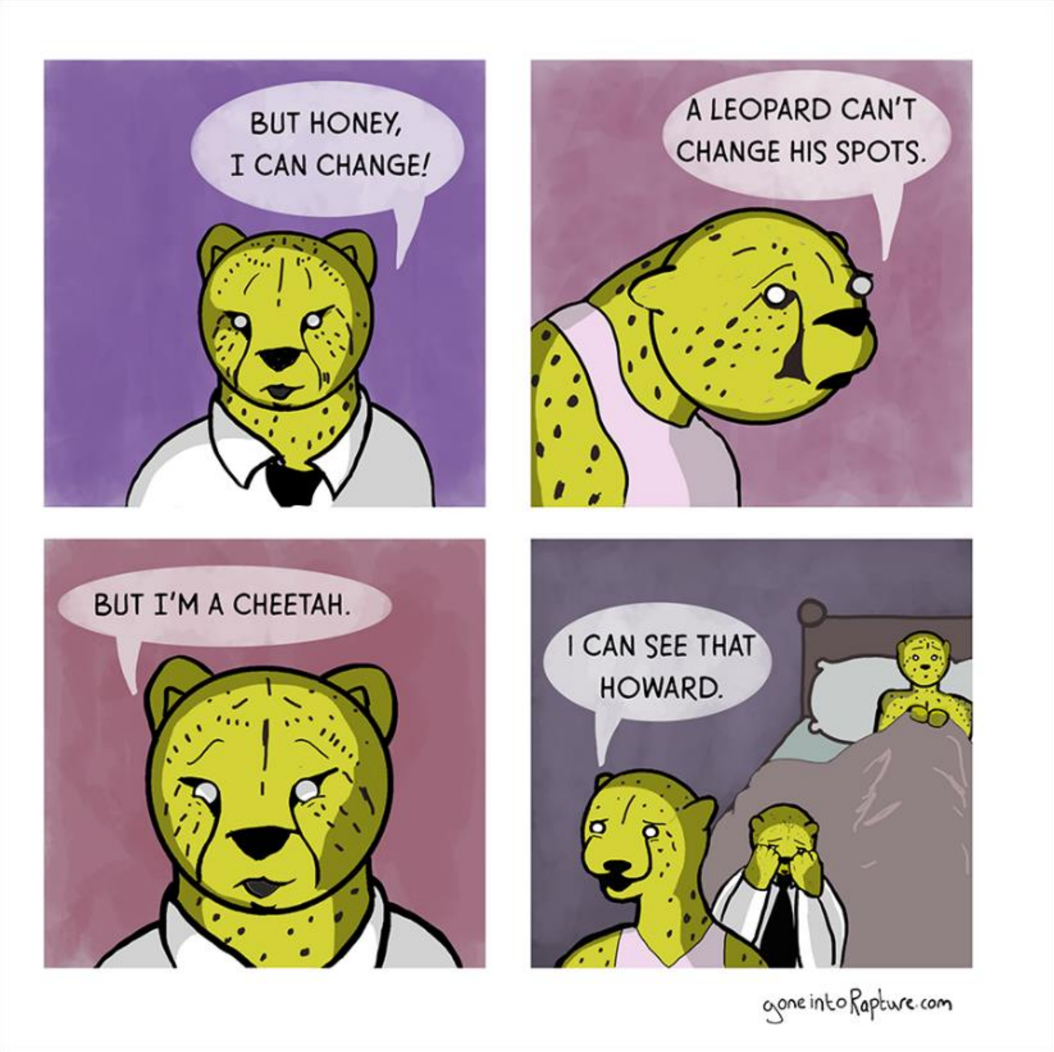


At the Same Time…

If you don’t take selecting financing partners seriously, you can make a huge mistake

“Look, you seem nice, and I don’t want to hurt your feelings, but I was really drunk when we met, got married and bought this house.”

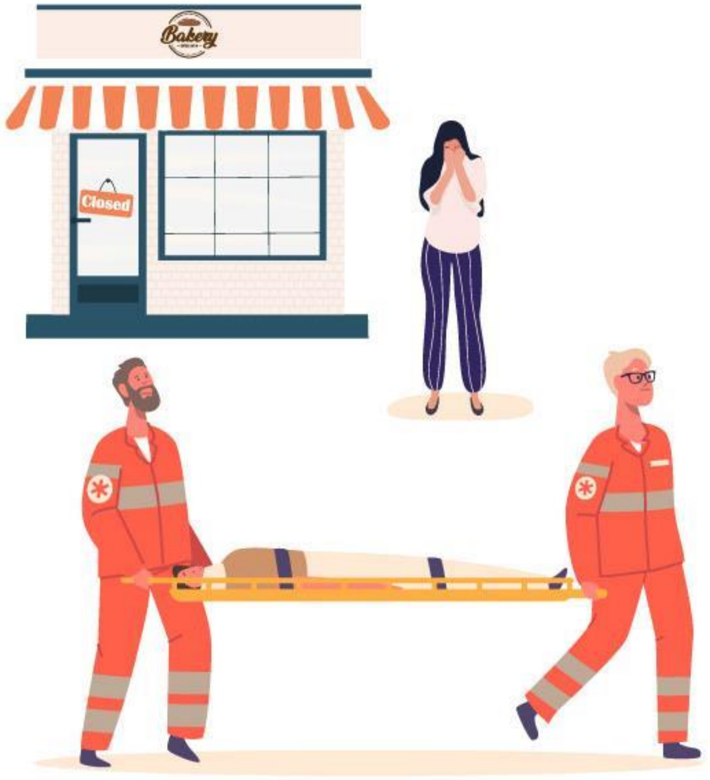
The Past Often Gives a Clue as to Future Behavior…



Why Understanding Business Finance Matters

Because No One Has a Crystal Ball

- Even in peacetime, a small but growing company is going to face situations it just did not foresee
- Some of these situations can pose existential risk to the company



Why Understanding Business Finance Matters
Because No One Has a Crystal Ball

- Or can be unexpected, but great opportunities to accelerate your business

➢ **Whether risks or opportunities, such situations often cost money in the short run!**

Why Understanding Business Finance Matters

Because Managing Gaps Can Be Harder Than It Looks

- CEOs without finance backgrounds often underestimate the difficulty of managing cashflow as the business grows
    - ✓ Customers may not always pay on time, but expenses like payroll, rent, etc. happen on fixed dates
    - ✓ Sometimes significant delay in doing something important is more costly to your business than the capital would be

Why Understanding Business Finance Matters

Because Managing Gaps Can Be Harder Than It Looks

- If you are too slowed down and/or focused on your cash position, you may lose out to a competitor who is not so slowed

Even if inside Ukraine, during the war everyone will cut you a break, this is NOT true once dealing with entities outside of Ukraine who have their own financiers to keep happy!

Business Financing Is a Very Normal Part of Running a Business in the West

- **All growing companies, whether start-ups or large corporations, routinely seek more capital.** Reasons include:

Limited or inconsistent cash flow for whatever the reason (e.g. world events, seasonality, etc)

Ease short term cashflow problems due to unforeseen expenditures/expenses that require a large, and often near-term payment, (e.g. sudden equipment / plant failure which requires immediate replacement.)

To expand the company in some way, (e.g. new office, new equipment, new employees, etc)

If they believe that securing capital may become much more difficult in future

What Are the Available Options?

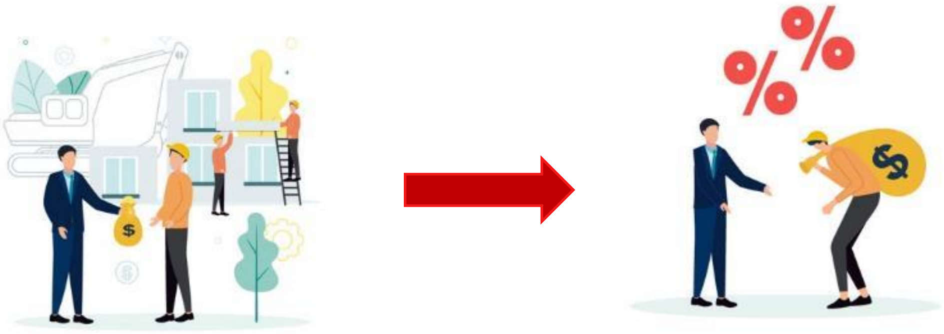
- **Debt Financing**
  - ✓ Loans
    - Secured
    - Unsecured
  - ✓ Lines of credit
    - Receivables factoring
  - ✓ Friends & Family / informal
  - ✓ With warrants

- **Equity Financing**
  - ✓ From individuals
  - ✓ From funds
  - ✓ Friends & Family / informal

- **Prepayments (Resellers)**
  - ✓ Royalties
  - ✓ Other prepayments

➢ Any combination of these

Debt Financing



Debt Financing - Introduction

" I'd like one of those loans I won't have to pay back. "

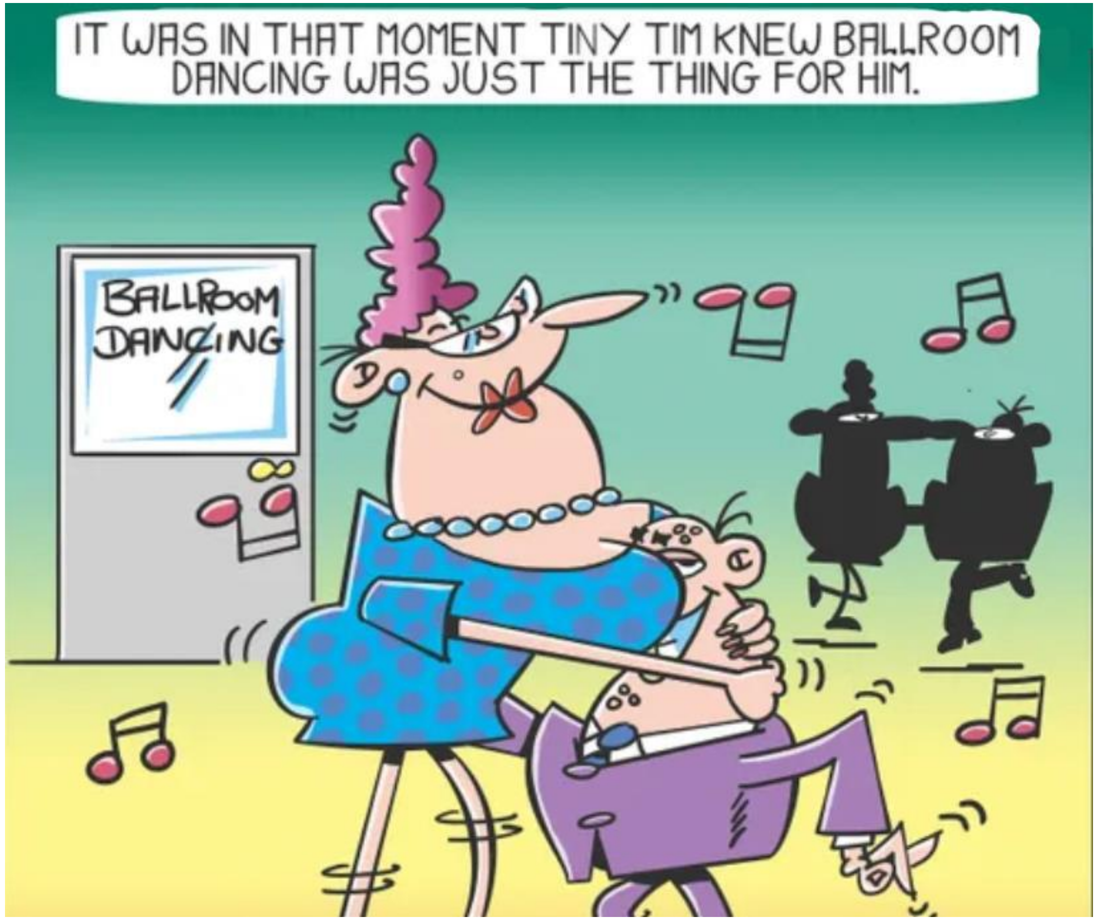
- Simplest example is a credit card
  - ✓ It's a normal part of daily life, though technically you are borrowing money when you use it
  - ✓ You could change your credit card provider every week if you wanted
- Money borrowed must eventually be repaid
  - ✓ Short of bankruptcy or renegotiation (which should never be assumed)
  - ✓ More and more interest will accrue until the money is repaid

Debt Financing – Who Does It?

- **Debt financing comes mostly from large financial institutions, not (relatively) smaller investors.** This is because one needs to do a large amount of lending to make significant money
  - ✓ The financial upside to the lender is limited with most kinds of loans; both laws and practicality limit the amount of interest they can get.
  - ✓ Some % of the time, the loan money is just lost

NOTE: In the West, interest rates are a fraction of what they are in Ukraine

Debt Financing – Who Does It?



- However, there are some important, relevant exceptions to this
  - ✓ Some investment funds can choose to do loans as a way to build the relationship
  - ✓ And/or to obtain stock

Business Loans

- Usually for a specific business purpose, such as purchasing specific equipment or some type of expansion of the business.
  - ✓ The loan must be used for the stated purpose(s)

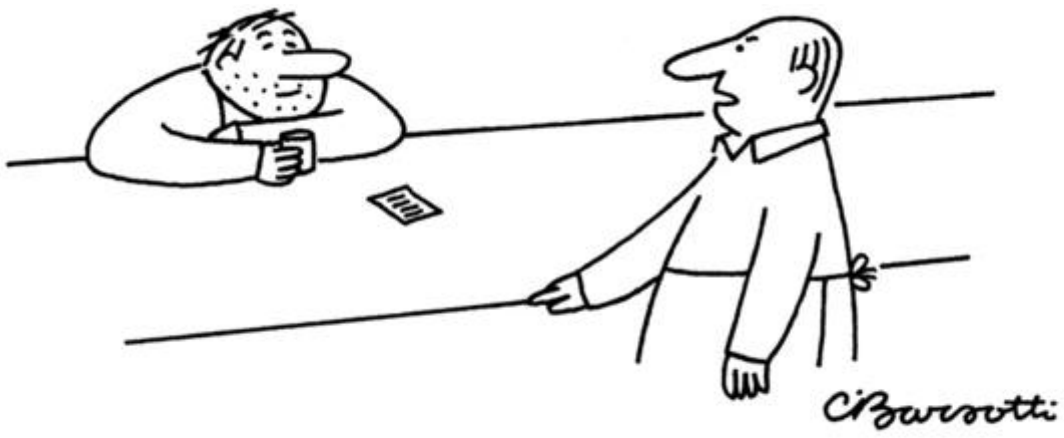
Business Loans Cont’d

- Almost all loans are ***secured***
- This means that lenders will require some kind of ***collateral*** This is an asset that backs the loan. Examples include:
  - ✓ Physical things, like property, valuable equipment, or a factory
  - ✓ Patents
  - ✓ The company itself, if it has contracts of value that are transferable

"COLLATERAL? SAY, CAN YOU TAKE MY MOTHER-IN-LAW?"

Other Types of Debt Financing – Warrants & Stock

- **Warrants** are the equivalent of stock options for entities rather than individuals
  - ✓ Or can also just be outright shares too
- Under what circumstances and at what price they can be exercised (acquired) is part of the contract



"I don't want stock options. I want you to pay your tab."

Other Types of Debt Financing

- Lenders can ask for other things besides interest
  - ✓ In fact they can ask for anything that is agreed upon with the borrower and is not illegal
  - ✓ Example: An investor in an art studio could demand some number of paintings by a given artist

Lines of Credit

- A **line of credit (LoC)** is like a loan, but it is ongoing and can be used for any purpose that the company wishes.
  - ✓ It is basically a maximum amount that the company can borrow.
- **Receivables factoring** is a common type of LoC in which one borrows against issued invoices

Debt Financing - Pros

"I get one every week. It's for people too busy for relationships."

- Often relatively impersonal: No emotional or ego commitment
- Lender has no involvement in the running of your business
- Obligation to the lender ends upon full repayment of loan plus all outstanding interest (and anything else promised in the loan agreement)
  - ✓ Unless as a result of the loan agreement, the lender also becomes a shareholder
  - ✓ However, lender arrangements that are pleasing for both parties are often repeated

Debt Financing - Pros

- Often a relatively easier & faster access to capital if you have a reliable revenue stream
  - ✓ Decisions often based on surface criteria
  - ✓ Lender doesn't need to understand as much about your business as for an equity investment
  - ✓ Lender does not need to believe in vast future potential of your company to do a loan

Debt Financing – What Can Go Wrong?

"You were the light of my life ...
until you forgot to pay the electric bill."

- Company must repay the loan, with interest, and satisfy any other conditions of the loan – or default. Default can be catastrophic
  - ✓ Means that you can lose the asset serving as the collateral
  - ✓ Or be pushed into bankruptcy
- The level of risk greatly influences the interest rate and other terms
  - ✓ More risk, higher interest

Even if inside Ukraine, during the war everyone will cut you a break, this is NOT true once dealing with entities outside of Ukraine who have their own financiers to keep happy!

What Do Lenders Want?

- Repayment without drama
- The ability to lend you ever greater amounts
- In some cases, the ability to acquire shares
- They want you to grow, and be around for the long haul, so they can keep making money from you
- How they make money:
  - ✓ Interest
  - ✓ Fees of various kinds
  - ✓ Profit from shares (if they get them)

Equity Financing

Equity Financing - Introduction

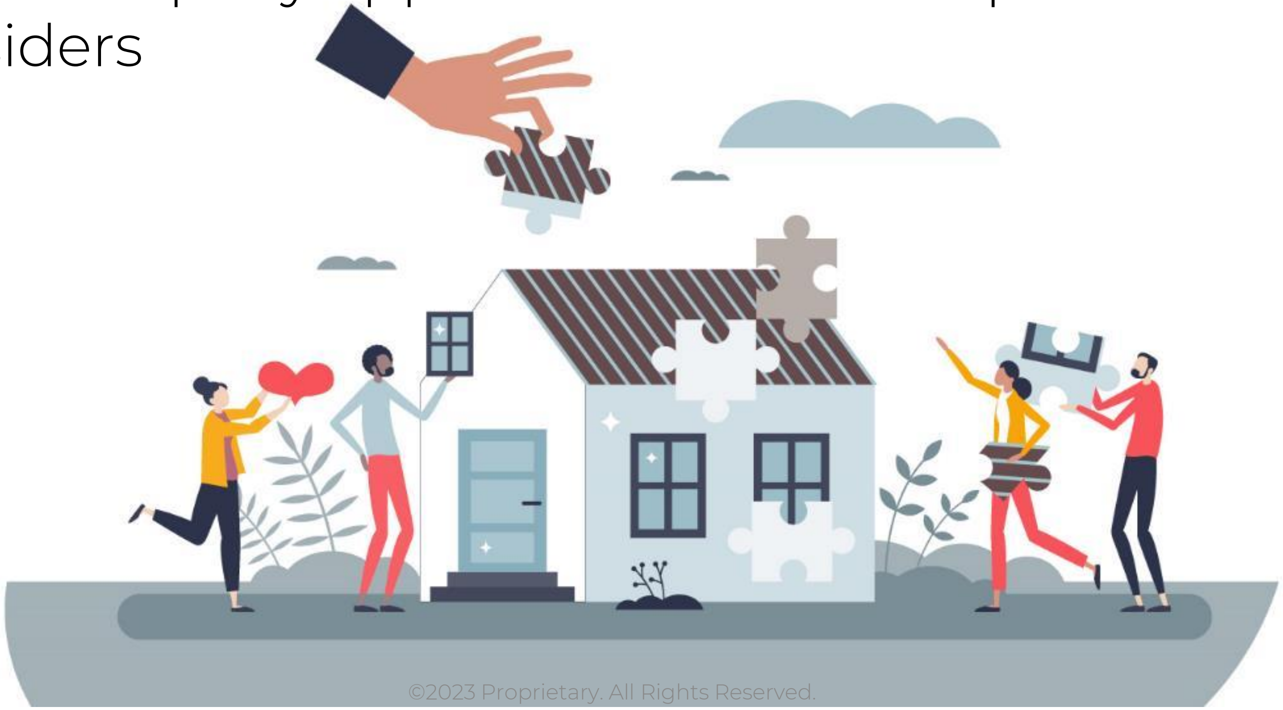
- Equity financing involves raising money through sale of shares of your business
  - ✓ No borrowing, so no repayments
  - ✓ Investor makes money only when you sell the company (or go public*)
- Usually involves sharing the control of your company with an investor
- Exact terms are negotiated and depend on the specific circumstances
- **An equity investment is for the life of the company; it's like marriage without the practical possibility of divorce**

Equity Financing – Who Does It?

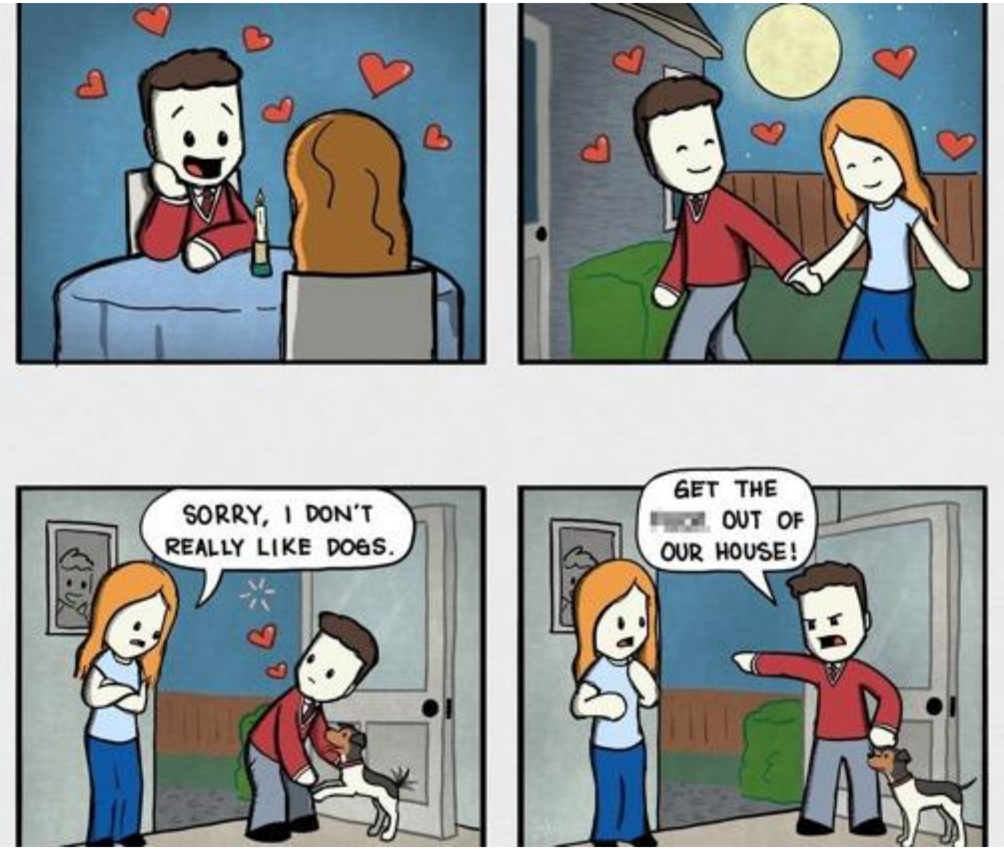
- People and entities who are chasing the big upside
  - ✓ And don't mind falling down most of the time in the process

Equity Financing - Pros

- With the right investor(s), equity financing can deliver more than just money; you may also benefit from connections, resources, guidance, skills and experience of the investors who have a stake in your business.
- May make your company appear more stable to potential customers and other outsiders



Equity Financing – What Can Go Wrong?



- Incompatibility/persistent disagreements
  - ✓ Foreseeable or otherwise
- If there are disagreements, investors can potentially oust the founders, and/or take over the company
  - ✓ The terms of the investment will govern the investors' power
  - ✓ As does the company's ongoing needs for capital

More Generally…

- Just as in personal relationships, things can change over time in ways you don’t expect

What Do Investors Want?

- To get multiples of their investment back through an exit → they want you to sell the company or go public
  - ✓ Otherwise they do not make any money

What Else Do Investors Want?

- To be associated with success, not failure
- To have rewarding interactions with the company
- Sometimes to strengthen their existing portfolio companies
  - ✓ Example: if they already have a machine vision company, it could benefit by an investment in a drone company that would become its customer.
- CYA, in the event of failure

Resellers

Resellers

Resellers take your products into markets where you cannot or would not go, whether ever, or for a long time

- Can be geographic (e.g. North America or English-speaking countries)
- Can be by vertical market / industry (e.g. selling surveillance drones in the insurance market)
- Can be packaging your component(s) in their products, thereby selling yours in their own

Having Multiple Resellers Is Common

- **Non-conflicting:** For example, one in North America, one in Asia
- **Conflicting:** Two resellers competing in the same market
- Resellers will generally try to insist on exclusivity ***within their market***
  - ✓ If they see your product as adding significant value
- Even when there is no direct conflict, there are only so many hours in the day →
  - ✓ Realistically, not all resellers will have the same level of priority when you have to make hard choices

"You told me to be more affectionate, so I got myself two girlfriends!"

How Resellers Can Pay You

- Prepayment of expected royalties on future product sales
  - ✓ In return for a negotiated discount
- Up front payments for exclusivity in a defined market for a defined period of time
- Payments for training their staff to sell and/or use your technology
- Prepayment & milestone-based payment for things like product modification, or building a new product

How Do Resellers Make Money?

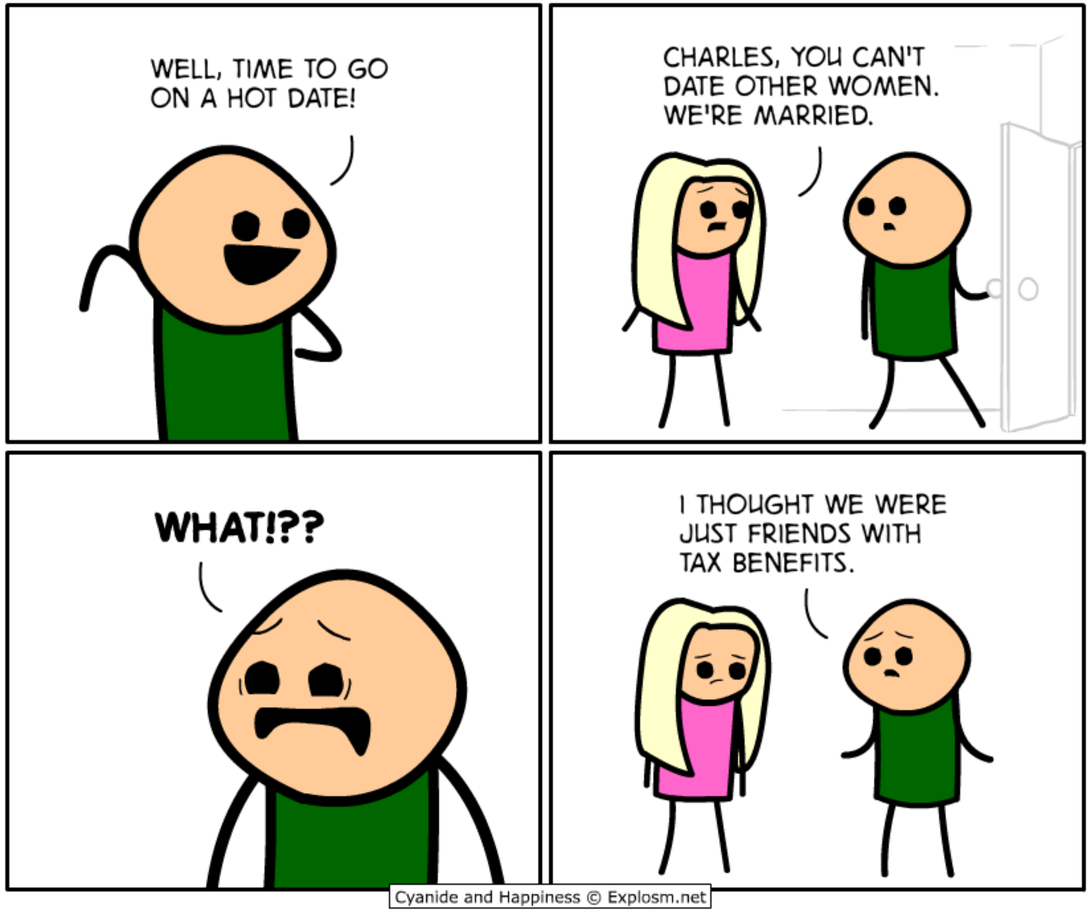
- May earn significant revenue for themselves by more than just selling your your products
  - ✓Servicing
  - ✓Customizing
- And/or generate more revenue opportunities for themselves as a result
- And/or strategic advantage
  - ✓Assuming exclusivity

Resellers - Pros

- Usually non-dilutive, though some resellers may demand equity as part of the deal
- Inexpensive, despite discounts for prepayment
- A good reseller will often “be the bank” if needed
- In most cases, wants your long term success…
- Needs your shorter-mid-term success
- Provide accelerated access to other markets, so revenue stream that you would not otherwise get for years – if ever

Resellers – What Can Go Wrong?
*If **You** Don't Deliver / Keep the Agreement*

- The reseller can ditch you
  - ✓ And then you could owe them money, depending on the terms of the contract
- Things change: what seems like a good deal today may not years later
  - ✓ Example: Maybe you couldn't sell to the USG now, but 3 years from now you could – except for the fact that the reseller has exclusive right for another 5 years based on the contract
- Exclusivity provisions most likely to cause friction and regret



Resellers – What Can Go Wrong?
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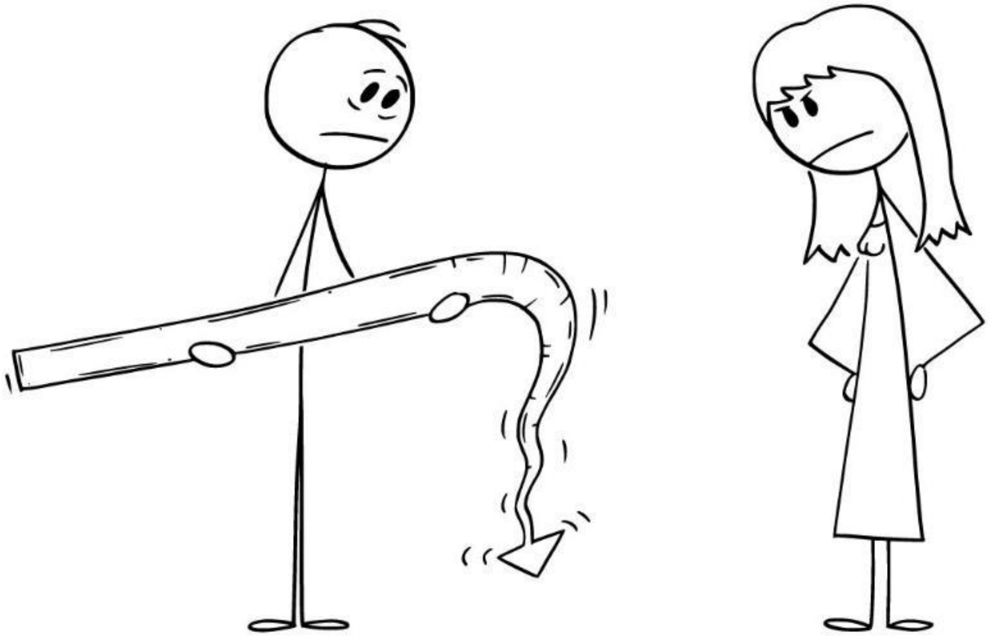


- Reseller fails to deliver promised revenue or some other material provision
- Dishonest reseller could try to steal your IP and/or cheat you out of royalties
  - ✓ But this is relatively rare and can be managed

What Do Resellers Want?

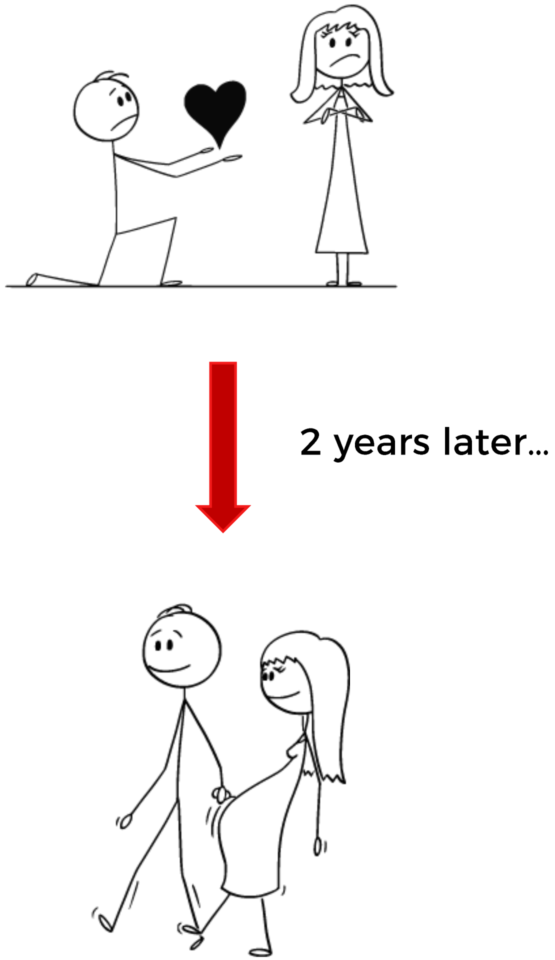
- They have concern for your welfare– a weak partner is a dangerous partner
  - ✓ Financially
  - ✓ Employee morale & retention
- Motivated to put their needs high on your to-do list
- Transparency – they don't like surprises that can adversely impact their business
- Want to avoid channel conflict
- How they win:
  - ✓ Selling tech & related services to a given market that is better than that of their competitors

"If you won't let me pay for dinner, at least let me pay for sex later."

Conclusion

There Is No One Right Answer

- Every option has its own trade-offs – including doing nothing at all
- Not all are even possible for every business
- **Things change:** the same business financing option which works right now, may not later on
    - ✓ Most businesses use or combine different options at different times
- Largest determinants of what is right for you are **why** you want the money,
  when, and **how important** it is to you



But…

- **For any particular situation, there are surely wrong ones.** Choosing from among the right business financing option(s) is critical for your startup
  - ✓ <u>For example, if you do not want to sell your company, equity investment not right for you</u>
  - ✓ <u>It’s got to be a good fit</u>

As In Life

- **The choice of the right partner(s) is at least as important as the method of financing**

"GLORIA, I WANT YOU TO MEET MY SIGNIFICANT OTHER."

These slides were prepared by women who enjoyed making them.

No animals were harmed in the process.

A little sense of humor never hurt anyone.

Important note: Chenope is creating this training series on business topics for miltech startups in Ukraine as part of a project with the Ministry of Digital Transformation of Ukraine. These materials are oriented specifically towards your unusual situation, as opposed to what one might find online generally about startups.

<u>Our sole purpose with the Business Financing module is to make you aware of the opportunities and risks of different options that may be available to you *as they exist in the West.*</u> Often this is quite different than what is true in Ukraine. Doing nothing is also an option, but it too has risks.

Chenope receives no compensation of any kind from any business financing entity. We ourselves are a 100%-employee owned startup, however we do use debt financing and have done deals with resellers of our technology. But what is right for us may not be right for you, and there are always tradeoffs in such decisions.

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These slides were prepared for Ministry of Digital Transformation of Ukraine