ENTREPRENEURSHIP & FAMILY BUSINESS

Navigating a 'friends and family' startup funding round

BY BRANDON ANDEREGG, *staff writer*

AS THE MEDIEVAL PROVERB GOES, blood is thicker than water, but the adage does not always ring true when mixing family and business.

Startups are hard pressed to raise funds at an early stage from angel investors, especially in Wisconsin, which is why accelerators often recommend a "friends and family" funding round. Family and friends are more likely to take a big risk on a family member's brand new, unproven business, said Molly Dill, director of gener8tor's gBeta program, an accelerator program for early-stage startups.

Dill

"This can help bridge the gap from the idea stage to the product stage, and then more investors are willing to take the risk when there is some customer and revenue traction to demonstrate," Dill said.

While textbooks may recommend entrepreneurs seek seed funding from family members, those relationships can become mired in conflict if not handled professionally, said David Borst, Family Business Legacy Institute executive director and chief operating officer.

Borst

"Blood is thicker than water until it turns green, until the money is involved," said Borst, whose firm provides strategic planning and guidance to family businesses. "Ultimately, I've seen families argue over darn close to a nickel, so you have to be cautious with these scenarios."

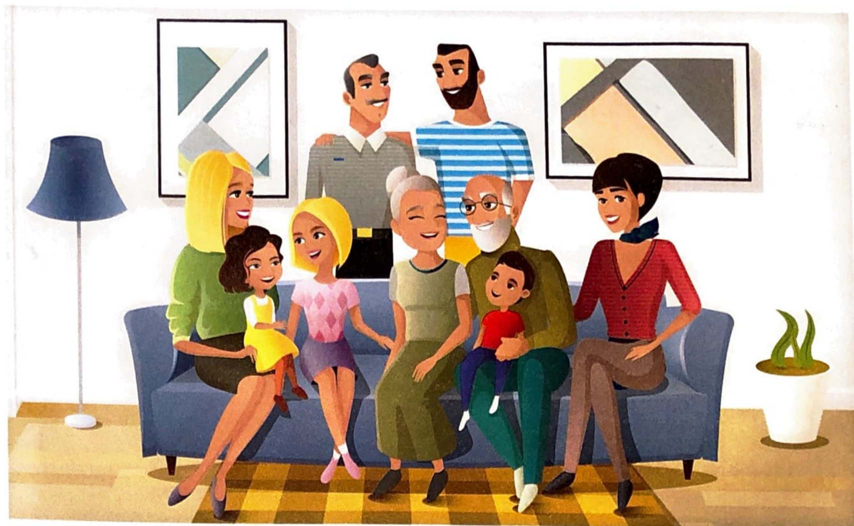
Emotions can have a huge impact on family business – interpersonal dynamics that, if given the opportunity to grow and fester, have the potential to send a business on a negative trajectory. Borst recommends basing decisions on solid business practices and leaving out emotion out when it comes to the dollars and cents.

"Make sure that whoever is investing is in fact aware of what that planning horizon is and what that financial horizon is," Borst said. "Whoever is doing the purchasing and asking for the funds, they need to have a legitimate business plan and that plan should be a pro forma looking out frankly five to 10 years, not two to three years."

Even if the family member is an experienced entrepreneur, the investor should still expect an agreement in writing and an official contract. This agreement should not be a haphazard do-it-yourself contract. Hire an attorney and an accountant familiar with startup investing to guide the process, Dill said.

Some family members may want to structure the investment as a gift or a loan, but this needs to be clearly defined or it can muck up future agreements when subsequent rounds of funding are raised, she said.

Structuring friends and family investments with a Simple Agreement for Future Equity (SAFE) or a convertible note is a common practice that gBeta recommends to its startup founders, but it isn't an investor's only option.



With a SAFE, the investor invests money in the company in exchange for the right to purchase stock in a future equity round subject to parameters set in advance in the agreement.

If the company fails, whatever money the business owner has left will be returned to investors. If the company grows, the company would likely raise more money and at this point, some investors would convert their SAFE into equity. If another investor decides to invest in the company in a priced round, the SAFE would turn into shares in the company.

A convertible note is short-term debt that converts into equity. For seed financing, the debt usually automatically converts into shares of preferred stock when a Series A round of financing closes. That means if an investor loans money to a startup as its first round of funding, rather than receive their money back plus interest, the investor receives shares of preferred stock as part of the startup's initial preferred stock financing.

The convertible note is often preferred over purchasing a stock security from a startup because typically the company has no product or revenue, making it difficult to set a price for stock at such an early stage.

Because of the risk associated with first-time entrepreneurs and startups, the family member investing should have realistic expectations. Borst said many family businesses do well, but when it comes to an early-stage startup, he would not invest unless he is planning to lose the money.

"If it's a child of mine, it's probably a situation where I'm giving them the money with the hope that something comes up, but also with the reality that it may fail," Borst said. "Usually, the very first businesses that a family member gets involved with are not going to be successful." ■