Key Challenges Faced by New Tech Companies

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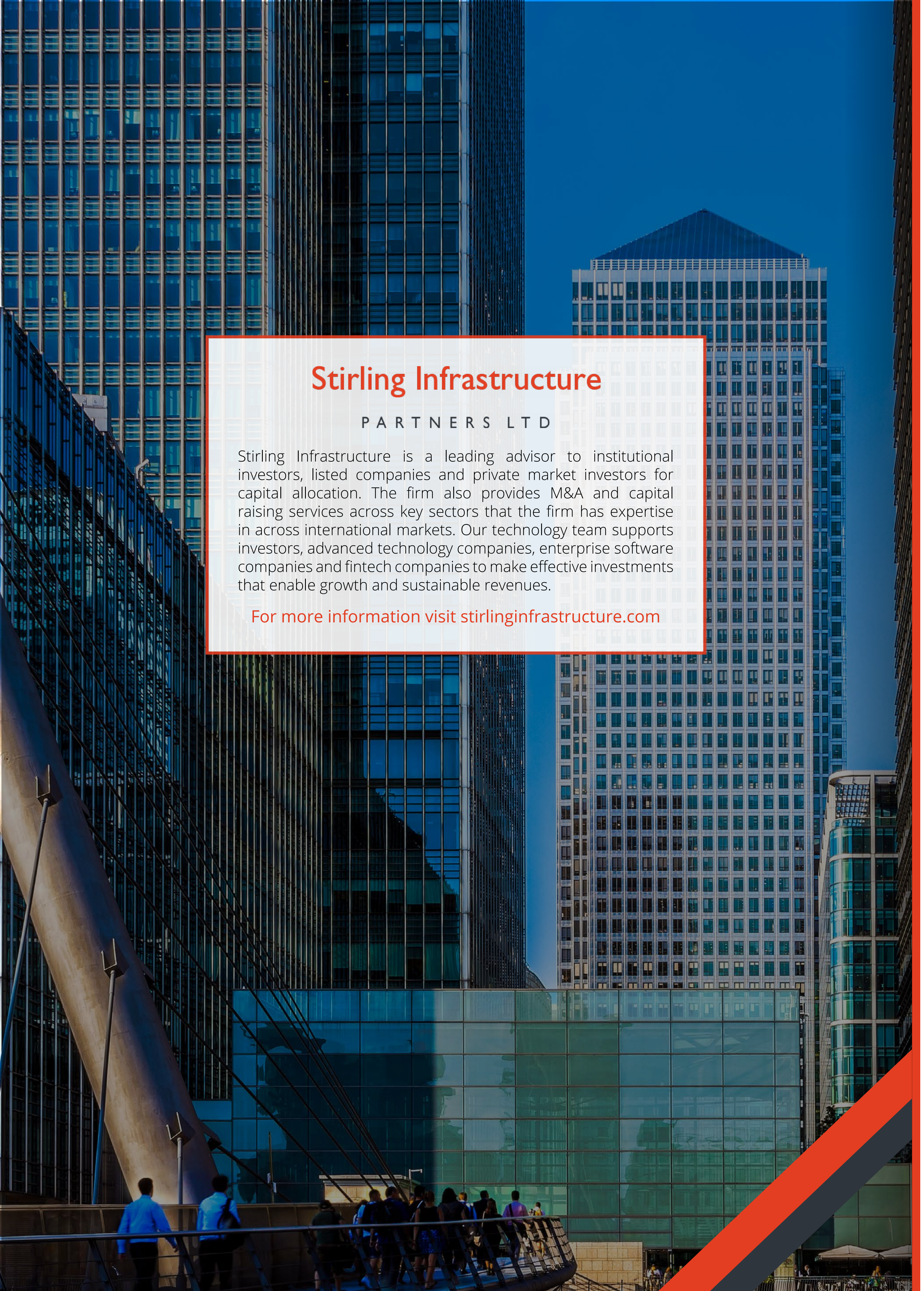
REPORT

Series A to Pre-IPO

Stirling Infrastructure
LIMITED



Stirling Infrastructure

PARTNERS LTD

Stirling Infrastructure is a leading advisor to institutional investors, listed companies and private market investors for capital allocation. The firm also provides M&A and capital raising services across key sectors that the firm has expertise in across international markets. Our technology team supports investors, advanced technology companies, enterprise software companies and fintech companies to make effective investments that enable growth and sustainable revenues.

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PURPOSE

This document provides an overview of the key challenges faced by new tech companies across all phases on its journey to achieve an IPO. Stirling Infrastructure provides strategic M&A advice and capital raising from Series A onwards to pre-IPO. This paper provides professional and insightful advice to enable companies to access capital and scale their businesses.

KEY CHALLENGES FACED BY NEW TECH COMPANIES

PROVING THE VIABILITY OF THE TECHNOLOGY

A study recently published by CB Insights analysed over 110 start-up post-mortems[1] looking for the key reasons of failure. They concluded that not being able to solve a market need was one of the fundamental reasons behind a start-up's demise, accounting for 35% of the cases studied. Market fit is the pivotal aspect of proving a product or service viability and one of the toughest challenges for entrepreneurs when designing and planning a potentially successful business.

The process of performing an initial evaluation of the viability of a new technology or business is known as the Proof of Concept (POC). A successful POC serves three main purposes:

- Verifying that the proposed new technology solves the problem that needs addressing;
- Corroborating that the product or service provided is valued by future customers;
- Determining if people are willing to pay for the proposed technology.

After achieving optimal results through the POC, the company can move on to other testing stages (minimum viable product, risk assumption test, billable viable product, etc). However, executing a successful POC is the key challenge for companies and innovators. Many of them do not even perform a POC and decide to launch their concept without performing a consistent and systematic analysis on its potential market fit.

LAUNCHING THE RIGHT TECH AT THE RIGHT TIME

Timing is a factor frequently ignored when launching new technologies and services in the market. For instance, the 2008-2009 global financial crisis enabled, through changing consumer behaviour, the launch of some of the most successful tech companies worldwide. This occurred despite significant funding challenges. Several similarities between the last financial crisis and the current Covid-19 pandemic makes us believe that a new wave of transformational technologies will arise in the short and medium term.

A couple of success stories from the previous financial crisis include Airbnb and Uber. The first was rejected by several investors during its first funding rounds, who argued that people would not rent a space in their home to a stranger. However, Airbnb was launched during the height of the 2008-2009 global financial crisis, which forced millions of households to look for alternative income sources, resulting in a significant adoption of the solution proposed by the San Francisco-based start-up. Similarly, Uber's success was boosted by drivers who needed to generate additional income in the middle of the financial crisis.

Likewise, many companies have been launched during unfavourable times. One of them was the online entertainment company Z.com founded by Bill Gross in 1999. It developed a consistent business model and attracted capital from several investors in its early stages. However, broadband penetration was too low at that time, requiring customers to perform several steps before being able to watch content. The company went out of business in 2003. Two years later YouTube was founded, taking advantage of higher broadband penetration rates to support its online streaming services.

PROVING THE STRENGTH AND SUSTAINABILITY OF THE BUSINESS MODEL

A company's business model is a description of the key elements that make it possible to deliver value and generate profitability. Such elements should incorporate a customer value proposition, a profit formula, key resources and key processes. The challenge for new tech companies lies in developing a business model that not only supports the growth and scalability of the solutions provided to consumers, but also incorporates flexibility to constantly adjust and innovate in response to changes in the ecosystem where they operate.

1 https://www.cbinsights.com/research/startup-failure-reasons-top/

Our research shows that there are four key threats that robust business models should overcome:

1. Imitation: Can competitors easily replicate the business model?
2. Holdup: Can customers, suppliers, or other players capture value created by the company by flexing their bargaining power?
3. Slack: Organisational complacency, neglecting the constant evaluation and improvement of the business growth strategy.
4. Substitution: Can new products decrease the value customers perceive in your products or services?

Designing a business model that incorporates the characteristics mentioned requires a deep understanding of the landscape dynamics and competitive ecosystem. Approximately 17% of start-ups fail because of the lack of a solid business model that supports the scale up of new ideas or technologies.

PROVING REVENUE POTENTIAL AND CUSTOMER BASE RELIABILITY

High revenue growth and solid customer base are reflections of a technology that successfully passed pilot tests and is supported by a sound business model. New technologies should grow exponentially after being officially introduced in the markets. In fact, one of the key factors considered by early-stage investors is the ability of a new product to grow its customer base and generate stable revenues. Some of the key metrics used to measure revenue potential include monthly recurring revenue (MRR), annual run rate (ARR), customer acquisition cost (CAC), average revenue per user (ARPU), and monthly active users (MAU) , among others.

The applicability of the metrics mentioned will vary depending on the business model. However, many tech companies choose to rely on a subscription-based model, which provides higher predictability (hence lower risk) on the expected customer base. According to Failory, 90% of young companies fail to grow and develop solid revenue metrics, with this being a result of diverse variables such as lack of product market fit, marketing mistakes, insufficient domain knowledge and innovation capabilities.[2]

MANAGING HIGH BURN RATES

IIn the venture capital industry, aggressive expansion and burning cash to achieve market share has become commonplace, with notable examples including the likes of Uber, WeWork, Revolut and many others. VC investors increasingly place importance and push ventures to focus on aggressive growth before profitability, especially for disruptive technologies. However, managing cash burn and securing enough runway before the next funding round remains an important consideration for the management team.

According to market intelligence firm CB Insights, running out of cash was cited as the primary reason for start-ups' failure.[3] In order to succeed, start-ups must carefully assess how much runway should be secured at each funding stage, what is the optimal funding round size at each funding stage and how to effectively manage the raised capital.

FIRST-MOVER ADVANTAGE

Another challenge for start-ups is establishing a strong competitive position. This must be established with detailed attention to important factors including intellectual property and patents, development of areas of competitive advantage, and strategic choices such as being a first-mover or a late-mover.

An essential part of this process is carrying out industry and competitor research which would yield actionable strategic insights, as well as developing thorough knowledge of the industry and its dynamics. Historically, whether it was the high-paced competition among VCR and PC developers or more slow-paced competitive dynamics in the telephones and vacuum cleaner markets, the successful venture is the one that effectively tailors its competitive strategy to its specific business environment.

Furthermore, the venture must deliver in other development areas, including timely funding rounds, which would act as a source of capital to support the venture's strategic priorities.

2 https://www.failory.com/blog/startup-failure-rate
3 https://www.cbinsights.com/research/startup-failure-reasons-top/

DETERMINING THE OPTIMAL VALUATION AT EACH STAGE OF FUNDING

In the last decade, median venture capital deal sizes increased twofold on average across early-stage and late-stage ventures, both in the US and Europe. When looking at corresponding figures, valuations have increased almost threefold in the United States and Europe. Over this period, there has been a large influx of capital into the venture capital space, both from traditional and non-traditional investors. This has given shareholders leeway to negotiate more favourable deal terms and drive valuations significantly. Moreover, over this period, start-ups have managed to scale faster and become more mature at each funding stage, which also contributed to considerably higher valuations and larger deal sizes.

This sparks a question: should ventures simply be aiming for ever larger deal sizes and greater valuations with minimal dilution? The answer is not necessarily. Many factors should be considered when determining an optimal valuation at each stage of funding. Is the valuation appropriate for the specific funding round? Would this valuation allow for valuation step-ups in the next rounds and a successful exit in the future? Is the pitch focused on KPIs or the bigger picture? Will the funding size meet the venture's capital needs or provide more than what is necessary? These are some of the important questions that need to be considered.

APPROACHING THE RIGHT CAPITAL TO ACHIEVE COMMERCIAL OBJECTIVES

A range of different types of investors participate from Series A to Pre-IPO, each with distinct characteristics, advantages and disadvantages. Considerable thought should be given to deciding which type of investor, or a mixture of them, would help for each funding round to achieve the company's commercial objectives and create strategic advantages.

Arguably, an even more important topic is how to protect the founders' interest when sourcing capital. How can founders minimise stake dilution, which tends to fall between 10-20% across each funding stage? How can founders negotiate favourable deal terms and validate their vision and the valuation in bringing strategic investors and new sources of capital to each capital raising round?

During seed rounds, VC investors tend to be aggressive in the deal terms, yet for early-stage companies they can offer significant expertise and the ability to guide start-ups as they grow their business. The Series A to Pre-IPO phase can include early-stage investors such as high net worth individuals (HNWIs), family offices and venture capital firms. At more developed phases in a capital raise other investors may include strategic investors, private equity firms and institutional investors. Family offices offer flexibility and larger sums of capital than angel investors, yet typically offer a less structured growth and investment path than institutional investors and listed companies in their processes.

Stirling Infrastructure's value is the firm's ability to assess and prepare a strategy to present a credible proposition to strategic investors, large institutional, listed companies, and sovereign wealth funds with which the firm has established relationships. Stirling Infrastructure's expertise is in capital raising from Series A to pre-IPO.

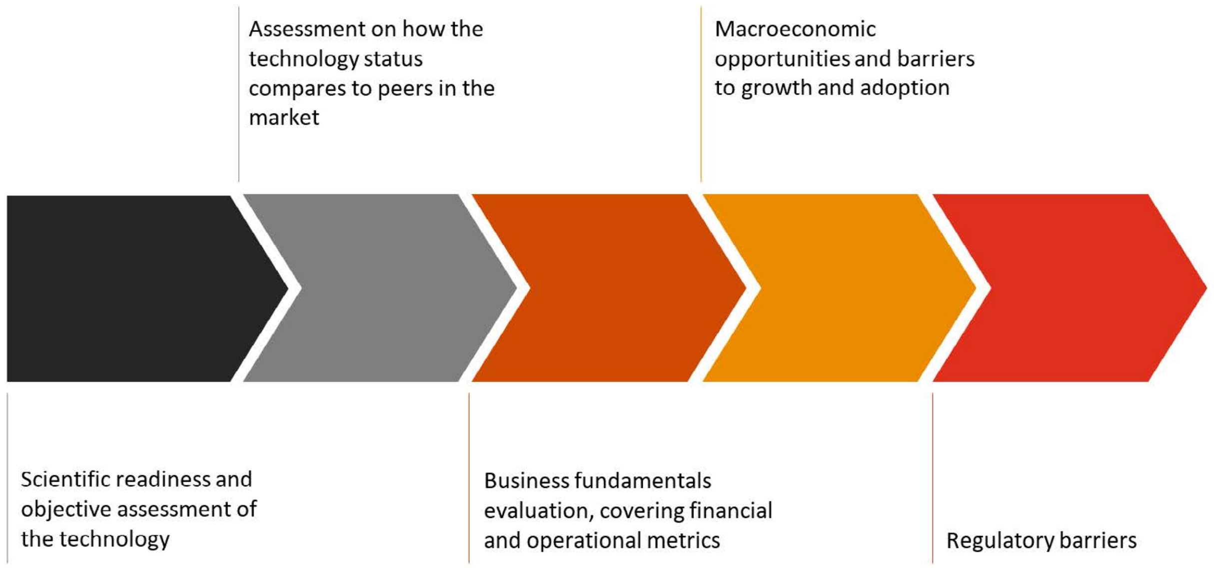
EFFECTIVELY SCALING INTO NEW INTERNATIONAL MARKETS

International expansion is a complex process and many notable failures have occurred, including eBay's unsuccessful move into the Chinese market, and Starbucks' failed expansion into Australia, to name a few.

Typically occurring at Series C stage and beyond, the logical next step for ambitious start-ups is scaling into new international markets. A new market may present exciting business prospects, high growth potential or ways to reposition certain parts of a company's operations. However, this step requires the right strategy development and execution to avoid painful mistakes, which no company is completely protected against. In this aspect, several key factors that are important considerations must be highlighted:

- Choice of market, where markets with the optimal strategic fit and the most potential to create economic value must be considered.
- Financing, one of the core considerations in previous challenges we outlined.
- Type of market-entry, which is a choice between organic expansion, acquisition, or through a strategic partnership.
- The competitive and customer acquisition strategy tailored for the specific characteristics of the new market.

STIRLING INFRASTRUCTURE METHODOLOGY FOR PREPARING COMPANIES ACROSS EACH CAPITAL RAISE ROUND THROUGH TO PRE-IPO



Stirling Infrastructure advises tech companies across all life stages (from Series A to pre-IPO) on investment origination and evaluation, capital raising, and go-to-market strategy, among others. At Stirling Infrastructure, our mandate is to enable the growth of innovative, scalable tech companies in the sectors where we have subject matter expertise and defined market relationships. These include technologies that will transform sectors including finance, energy, infrastructure, transport, and real estate across international markets.

ADVISING ON BUY SIDE TRANSACTIONS

When advising on the buy side of a transaction our firm has the capabilities to support clients with on the evaluation of the financial, scientific and regulatory aspects on technologies through Stirling Infrastructure's experienced transaction team and our proprietary investment appraisal model. To provide an outline of our methodology, we focus on the following set of metrics and aspects:

i. Objective assessment of the technology

We provide objective assessment and guidance for products and technologies in the research, development and deployment stages. We aim to answer whether the product or technology will be able to create economic value, be commercially viable, technically implementable and be ready to be successfully taken to the market upon deployment.

ii. Assessment on how the technology status compares to peers in the market

We conduct thorough assessment of peer companies, the competitive landscape and rival technologies to provide detailed and actionable insights into the relative performance of a company, its areas of strength and its weaknesses.

iii. Business fundamentals evaluation, covering financial and operational metrics

We utilise our extensive financial expertise to assess the financial management of the company, including the strength of its balance sheet, cash flows, operational performance and the management team. We support our client in advising on how they can improve on acquisition, the optimisation of the company's financial management. This can allow companies to face their next development and funding stages from a position of strength.

iv. Macroeconomic opportunities and barriers to growth and adoption

We assess the external market environment, macroeconomic conditions and opportunities, business factors such as barriers to growth and adoption of the product or technology. We support investors in navigating and understanding key factors that must be considered in order for the company to achieve commercial success and high growth.

v. Regulatory barriers

We use our legal and regulatory knowledge to help investors understand regulatory issues. Where necessary, we are able to provide a shortlist of law firms to advise on specific industry and geographic issues, helping them better understand the local regulatory framework and barriers. Our clients are able to make investment decisions with confidence through a well-defined appraisal process.

vi. Valuation

We help investors understand the opportunities and risks of investing into the company and to support our clients in determining whether they are paying a fair market valuation for a stake or the acquisition of the company.

OUR EXPERTISE IN SERIES A TO PRE-IPO TECH CAPITAL RAISING

After gaining a deep and objective understanding of a new tech business through the execution of our methodology, we find ourselves in a strong position to support our clients by:

- Advising on the detailed preparation and optimal valuation for a successful capital raise from Series A to Pre-IPO.[4]
- Developing a capital raise action plan by defining the most favourable sources of capital, developing documents and marketing materials, as well as setting up meetings with potential investors.
- Leading the execution of the capital raising process, managing negotiations with institutional investors and listed companies, and protecting the interests of the shareholders through all capital raising rounds.

Our team specialises in the following sectors:

- Smart cities
- Energy tech
- Transport tech
- Water tech
- Prop tech
- Fintech
- Enterprise software

Our experienced, diverse, and international team of financial, legal and scientific professionals, as well as our strong track-record on capital raising advisory, assures a successful path to overcome the key challenges faced by technology companies and achieve their growth objectives.

4 We will consider seed stage companies on a highly selective basis.

FOR FURTHER INFORMATION

This report is a primer that presents Stirling Infrastructure's expertise in advanced technologies, enterprise software and fintech markets. Our strengths include raising capital from institutional investors, listed companies and private market investors. The firm provides access to a global network for our clients to scale their business interests and also provides comprehensive M&A transaction services. If you wish to discuss your requirements, please contact Stirling Infrastructure.

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