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Corporate Law Update
November 2017

Pursuing Outside Funding: Don't Get Stumped!

When start-up and emerging growth companies pursue professional investors for equity funding such as venture capital or angel finance, they should be prepared for certain inquiries that these investors will typically make. Even though these questions should be anticipated, many companies are often not adequately prepared to respond, which lowers their chances of obtaining funding.

Product versus Service Company. One question that technology companies are often asked is, "Are you a product company or a services company?" Or to state the question in more detail, "Does the company obtain its revenue principally from the sale or license of a product or from providing services to customers?" The reason this a key distinction is simple: **scalability**, which is the ability to rapidly increase product and sales if warranted by customer demand. True product companies typically scale quickly and easily by taking actions such as adding second shifts etc., and 'pure' software companies can scale easily. In contrast, services companies are typically difficult to scale since the ability to grow is limited by the ability to retain and train staff. Investors who consider early stage companies want to find companies with the ability to grow quickly. In most cases this means their interest is in product companies, not services companies.

So from an investor perspective, the preferred answer to this question is usually "we are a product company." Some companies may begin as a service company, but in the course of delivering services identified a need and developed a product to meet the demand. In that case, the accurate answer might be "We began as a service company but are now adding a product component [or transitioning into a product company]." In either case, it is vital to present financial statements for past performance and pro forma projections that draw a clear distinction between the costs and revenue related to the service portion of the business versus the product-related operations. An explanation of cost structure, fixed versus variable, is often relevant too.

Traps to Avoid. There are at least three ways for a company to lose credibility over their response to this question: (1) not having a clear answer of any sort; (2) trying to present itself as a product company when in fact it is a services company attempting to make the transition to a product company; and (3) presenting financial statements/projections that create a false impression of revenue being product-based when in fact it is services-based.

Frequent Variations … and Their Value! Two factors make product company/service company question more complex to answer for many tech companies. First, many technology companies generate significant revenue from services that are tied to the product, such as implementation and maintenance services. This type of service is different in nature from web development, app development, etc.; the company may be the only business qualified to implement or service their product, so there is much less competition. A second factor is the shift to SaaS business models. A software company that has transitioned from traditional licenses to SaaS arguably has transitioned from a product to a service company. However, SaaS is often the exception to the general rule disfavoring services companies if the company has that most precious of acronyms – ARR (annual recurring revenue).

As a result of these factors, the revenue of a technology company may fall into several categories: (1) hardware sales; (2) traditional software licensing; (3) SaaS licensing; (4) services such as implementation and maintenance; and (5) services that are not based on the company's proprietary software.

Market Size and Definition Matter! Another question that companies should anticipate being asked is, "What is your market and its size?" Market size is often a key determinant of likely investor interest. However, defining the relevant market is often complex. Consider a software company that is developing a salesforce compensation management product. The market arguably consists of every business with a sales staff that is compensated wholly or in part based on commissions or similar incentives. However, the true target market for this hypothetical software company is likely large to mid-size organizations with complex sales compensation packages that can afford the company's software. Accordingly, this company needs to take three steps to define their market. First, it needs to determine the likely size of organization that is their addressable market – is it companies with over five million dollars in sales, or five hundred million dollars, or five billion dollars? Second, it needs to consider which large organizations have sufficiently complex sales compensation packages to be likely adopters of a software product in this area. Finally, it needs to research and analyze available data to calculate the size of the market as defined.

You Must …! So, before you get in front of investors, be sure that you: (1) have fully considered the type of company you are; (2) are prepared to provide financial statements for past performance and projections of future results that clearly distinguish between service and product revenue; and (3) are ready to provide a fully-considered answer to the question, "What is your market size." These steps all take time, but it is definitely time well spent.

FisherBroyles partners can assist companies by providing experienced counsel through the complex process of securing outside funding. If you would like additional information, please contact any of the following FisherBroyles partners:

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