OULUN SEUDUN
AMMATTIKORKEAKOULU

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Financing of Start-up Company and Private Equity Investor

Do I Need To Sell My Soul For The Money?

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Kimmo Veki
Master's thesis
2017
Industrial Management
Oulu University of applied science

TIIVISTELMÄ

Oulun seudun ammattikorkeakoulu
Koulutusohjelma, suuntautumisvaihtoehto

Tekijä(t): Kimmo Veki
Opinnäytetyön nimi: Start-up company financing and private equity investors
Työn ohjaaja(t): Hannu Päätalo
Työn valmistumislukukausi ja -vuosi: Kevät 2017
Sivumäärä: 96 + 1 liite

Pääomasijoituksen hankkiminen on usein start-up yritykselle elinehto. Pääomasijoituksen tavoitteena sekä yritykselle että pääomasijoittajalle on yrityksen arvonnousu ja liiketoiminnan kasvaminen. Pääomasijoitusprosessi on pitkä ja sisältää useita eri vaiheita alkaen sopivan pääomasijoittajan etsinnästä päättyen pääomasijoittajan irtautumiseen yrityksestä.

Tässä opinnäytetyössä kuvattiin pääomasijoitusprosessia start-up yrittäjän näkökulmasta. Teoreettisessa osuudessa pääomasijoitusprosessia ja sijoittajan mahdollisuuksia suojata investointia käytiin läpi vaiheittain. Laadullisessa tutkimuksissa pyrittiin saamaan käsitys viekö ulkopuolelta tuleva sijoittaja yrittäjältä toimintavapauden ja miten yrittäjyys muuttuu pääomasijoittajan mukaantulon jälkeen.

Valmis opinnäytetyö antaa tietoa pääomasijoittamisesta ja sen prosesseista.

Asiasanat:
Rahoitus, Start-up, Pääomasijoitus, Oulu

ABSTRACT

Oulu University of Applied Sciences
Master of engineering, Industrial management

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Title of thesis: Start-up company financing and private equity investors
Supervisor(s): Hannu Päätalo
Term and year when the thesis was submitted: Spring 2017
Pages: 96 + 1 appendices

Foreign capital is usually the only way to survive for the startup company. The mutual goal for the company and the investor is value creation and growing of the business. The venture capital process is long and includes several phases from searching for the investor to exit of the investor.

In this thesis, the venture capital process has been described from the target company's point of view. In the theoretical part the venture capital process was explained through literature review. After the literature review the empirical research is done as qualitative research by using case study research method. Semi-structured interviews are used to collect data from companies. The case companies are five young technology firms, which have been established in Oulu, Finland. These companies are utilizing strong local technology expertise and competences and targeting to grow fast to global players in their area of business.

Complete thesis can be used as guide for the entrepreneur who is looking for an investment in the company. The thesis also provides information of the venture capital process and capital investment.

Keywords:
Financing, Start-ups, Capital investment, Oulu

ACKNOWLEDGEMENTS

The time of studies of Industrial Management has been interesting journey. I would like to thank many people and entities who have made this journey possible.

During the learning process, it has been a joy to be part of this community. All the wonderful people at the Oulu university of applied science, thank you for the support, thank you for the refreshing the how to learn and discover new ideas. Thank you also for the valuable comments that you have provided me in lectures during autumn 2013. I would like to give special thanks to Tauno Jokinen, Bärbel Fink, Pekka Auvinen, Marko Juntunen, Lasse Pesonen, Hay Geraedts, Henry Jarva, Elina Pernu, Veikko Laine and all the other lecturers who have given me new boost for studies. Especially, I must give my gratitude to my supervisor Hannu Päätalo, whose expertise and support made it possible for me to work on this topic. He always helped, guided and pushed me to write and complete my thesis.

Last but not least, this journey would not have been achievable without the support of my wife and sone. They always encouraged me and inspired me to chase my dream. This could never be finished without your support. Minna and Riku, thank you for everything. I love you both.

Oulu 10.04.2017 Kimmo Veki

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1 INTRODUCTION

It has been said that a bad economy is a good financial climate for a startup. When the big companies will reduce their labor, or do not hire new workers from the recently graduates due to global economy changes then various new start-ups will be established.

The start-ups employ many qualified individuals in a range of industries, and offer a varied, intensive and in-depth experience for workers who does not want to do boring work in a big company. Working for the startup give board learning possibility to many things that are necessary for the development of a successful business, in an experimental and creative environment. Also, working in a small team may help the employee to see how their own work will affect to the business, both in good and bad. The scope of the startup employee's work is far greater than an employee working in a single department for a large company, and so they often gain a richer and more varied professional experience.

The generic problem in start-up companies is the lack financing. How to ramp up initial operations into such level that it can operate? Each step will require money and very soon the startup company is knocking on all the possible doors to get money for surviving and evolving. Only very few start-up company can make money without aid from investors.

It is important to have a solid business plan in place, and to seek out people who might invest in business. There is a limited amount of funding available to startup founders and competition grows all the time. How to find the investor who could invest to my business and in what terms? What the investors are looking for?

In simply, the investor is looking for a company with a clear and scalable business model they can get behind and help grow. In this study the investors way of work has been investigated, what they are looking for when they are investigating the potential target companies and how the investment process goes on. Also how the entrepreneurs felt when investor came as part of the company and what kind of role they took has been investigated.

The theoretical part of the study is done by collecting findings from relevant theory publications and empirical research papers on the relevant areas. Financing of SMEs has been the subject of many research projects and there is lot of material available.

Chapter two gives background and the limitations for the study. Next, in chapter three, the study presents the theory behind financing in startup companies. This is followed by chapter how investors can protect their investments. Chapter five handles the research methodology. After this, in chapter six, the study analyses the results. Chapter seven and eight concentrates to the analysis of the data and conclusions.

1.1 Topic and research question

The purpose of this thesis is to investigate the high-tech start-up companies which were required to finance their activities with external funding. How did they find the investor, how the investment process went and what kind of limitations the investor brought within?

In this thesis, the investment process has been investigated from the theoretical point of view and also explained the financing possibilities. However, the focus was to clarify how the passionate entrepreneur who has the “total” freedom of operate will handle the situation where the external investor will give something but at the same time gives strict boundaries for the operations.

Research question: *How the entrepreneurs felt the situation when the financier has strict rules which limited the freedom of operating.*

From the investment process point of view is beneficial to *understand the target company selection criteria, as well as the investment process from the perspective of a founder*. In addition, the objective is to *investigate the sources of finance and correlation to the business plans.*

In this study, the object of the study is limited to startup companies in Oulu region which have acquired external funding and are at seed or early growth stage of

lifecycle. Also, one commonality of the companies is that all are limited companies.

1.2 Research methods

The report is divided into two parts – theory and practice. First the theoretical background has been studied based on professional literature as a literature review. After the theoretical part the assumptions has been tested through the qualitive research method and theme interviews.

The research-based section of this thesis is done by using the qualitative research method and choosing case study as a research strategy. The empirical data were collected by using the theme interview method, by interviewing entrepreneurs who has received the financing from the external investor. In theme interviews the accurate form of questions and the order of the questions may change but the themes are the same. (Hirsjärvi et al., 2008, 203)

The interviews have three different themes:

1) financing of the start-up company,
2) what the finances are requiring as opponent and
3) improvement proposals.

The outcome of the research will be analysis with improvement proposals.

2 OBJECT UNDER THE STUDY

This chapter narrows down the scope of the study. First the definition of a start-up company is explained. After that, it continues with the description about the company lifecycles and how the financing needs are related to that. Finally, the limited liability company -corporate form is explained and characteristics related to that are opened.

2.1 Startup company

The term “startup” has been used quite popularly over the past few years to describe young firms which have only a few entrepreneurs with passion to achieve something new. On the other hand, the huge tech companies can be defined as startups. What is then a startup?

There is no clear fact based rule on defining a startup. Revenues, profits, and employment numbers depends on companies and industries and may vary a lot. Usually startup contains characteristics like innovative, passionate, problem solving, risky, growing. Someone could describe startup as state of mind. The startup cannot be defined by the company age- a company five years old can still be a startup. On the other hand, maybe ten years old would start to be a something else than startup. (The Forbes 2013)

Start-up can be defined as a “human institution designed to deliver a new product or service under conditions of extreme uncertainty” (Ries 2011, 8).

Usually most startups end being startups after first years. This is often seen in factors that indicate a graduation from startup: acquisition by a larger company, offices in several locations, revenues in multimillion level, employee amount in several dozens, the board have more than five people, and founders who have personally sold shares. Usually when a startup becomes profitable it is likely moving away from startup.

The key feature is its ability to grow. A startup is a company which is designed to scale very quickly. It is this focus on growth unconstrained by geography which differentiates startups from small businesses. (Kormilainen 2015, 20)

2.2 Company lifecycle

The lifecycle model gives a good illustration how the company and business will change over the time. Those models will describe the different stages and consequences of company growth as a process and hence gives more versatile image of the company than only growth indicators. The growth is often equated with success. (Baum et al., 2001, 292).

All lifecycle models have the same basic idea. They describe the company's growth in the s-curve, which shows the development of the company's growth phase to another. According to Wiklund (1998, 32), the life cycle models focus on the changes that growth brings to the company, its structure and strategies, and explain the importance of the change in the company. The models highlight the growth brought about by the problems that the entrepreneur must find the appropriate solutions. The company will grow from stage to another stage and previous stage gives impulse to the next. The organization will be developed constantly when moving from stage to another and that is seen in operations and quality.

The lifecycle models differ in amount of stages and also does the model include the preparation stage (before establishing the company). Even though the number of stages varies all the models includes at least these stages: Seed, Growth, achieved a market share and / or expansion, as well as the Maturity. (Dodge & Robbins 1992, 28).

The models are based on assumption that companies will go through all the stages when they develop and grow. (Birley & Westhead 1990; Wiklund 1998, 32–33.) In reality, the companies will not go through all the stages or the order of the stages may vary and therefore the development pattern is different. Individual entrepreneur or team can make the remarkable difference by their motivation, decisions and acts. (Tang et al. 1997, 29-34) Most of the startups will never move from first stage to another.

Joint global definitions of the various stages of a company do not exist, but they could be described as follows.

The **Pre-seed** is the stage at which there may be a team and an idea, but not necessarily even a company. Investment enables the first stages of product and idea development. Increasingly, incubators are taking over this investment phase that allows the business angel to focus on the other stages below.

In the **Seed stage**, the Company has no sales revenue, but it needs to produce the products in order to have something to sell. Funding is needed for product development and product test marketing when the products have not yet been commercialized. The investment is used in verifying and starting up product development or a business model.

The offices, sales channels and logistics need to be arranged, although no sales income. Its credibility is weak; it does not have regular customers and the company uses great efforts and resources for acquiring new customers.

Most of the Finnish private equity investors will not invest in early stage companies (Pylkkänen, 2008, 40). However, there is a great number of investors who will invest in seed stage companies.

The **Start-up/survival** is the stage where the existing team has grown, moved out of the garage into its own premises and launched the first version of the product. At this point, there are already costs because the company must buy materials, the workers need to pay salaries since the beginning and entrepreneur need to live. Turnover is generated but it is not yet sufficient to cover expenses

An angel investment is usually used for product and market development or working capital, in other words, to get over the "valley of death".

In the **later growth stage**, business expands from the company's home town to the international market and trade booms. Incoming cash flow exceeds outgoing payments and the business begins to accumulate cash. The investment is used to accelerate growth.

This stage also requires a significant amount of capital. The goal of marketing efforts at this stage is to differentiate a firm's offerings from other competitors

within the industry. Thus, the growth stage requires funds to launch a newly focused marketing campaign as well as funds for continued investment in property, plant, and equipment to facilitate the growth required by the market demands. However, the industry is experiencing more product standardization at this stage, which may encourage economies of scale and facilitate development of a line-flow layout for production efficiency. The key issue in this stage is market rivalry. Because there is industry-wide acceptance of the product, more new entrants join the industry and more intense competition results.

During the growth stage, the life cycle curve is very steep, indicating fast growth. Firms tend to spread out geographically during this stage of the life cycle and continue to disperse during the maturity and decline stages. As an example, the automobile industry in the United States was initially concentrated in the Detroit area and surrounding cities. Today, as the industry has matured, automobile manufacturers are spread throughout the country and internationally.

In the **expansion stage**, the company already has considerable turnover and aims to expand to ever-new markets, product groups or industries.

The larger companies which are seeking growth can increase their capital via listing their shares on the stock exchange also. The listing also allows to later share issues. In the past, in addition to the listing on stock exchange, the only option in order to obtain financing for larger investment was a bank loans, but banks have been replaced nowadays by private investment companies (Donovan 2007, 6.)

Figure 1 describes the different stages of funding. At the beginning the funding comes from business angels "angels" and the friends, family and fools "FFF". The Longer the company survives without external funding the better. it is easier to get investor to company when most uncertainties have been clarified (Lainema, 2011, 85-86.) The venture capitalists' "VC" are usually investing after the "Valley of Death" has been passed and the company has already begun to make a profit.

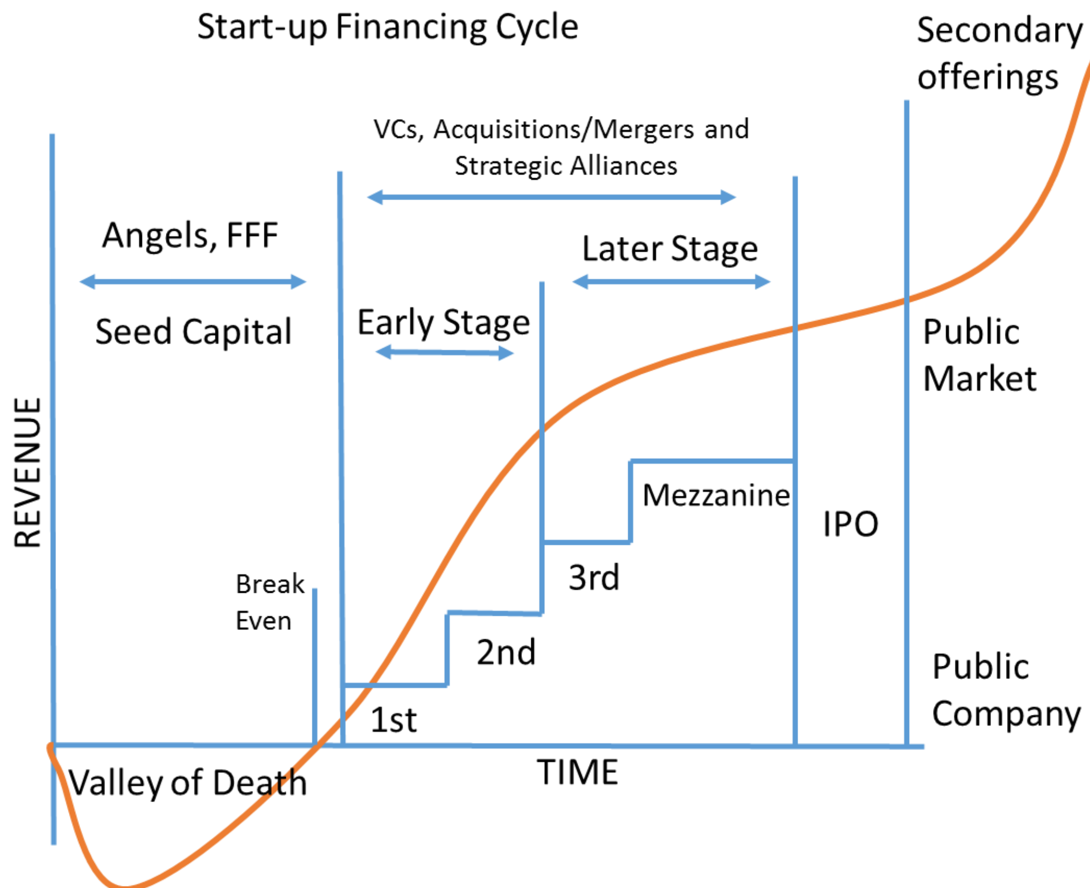

FIGURE 1. Start-up phases and funding

2.3 Limited liability company

A limited liability company may have been established by any of the natural or legal person (OP-Pohjola-ryhmä 2011, 8). A limited liability company's financial structure is efficient and flexible which enables the company's market opportunities. Corporation's financial structure supports by the various stakeholders' needs. (Mähönen et al., 2006, 34, 46.)

The establishment of a limited liability company can be divided into four stages: a foundation agreement, the marking of shares, payment of the shares and the registering in the trade register (Mähönen et al., 2006, 207). The company is not legally existing before it is registered into the trade register. The law protects the creditors of the acquisition, persistence and transfer of capital outside the company's capital. (Mähönen et al., 2006, 18)

FIGURE 2. Limited liability company benefits

The limited liability companies' popularity comes from the lack of personal debt responsibility. The share owners are not personally liable for the company debts. However, the debt liability is usually personal in start-ups. Quite often the entrepreneur must give personal collateral to the firm's liabilities and thus take a personal responsibility for the debt business. Another advance of limited liability company is to easy transferability of shares. A limited liability company shares are freely transferable to third parties, which means that the leaving the company is easy and ownership can be quickly converted to cash. (Mähönen et al., 2006, 29)

The highest decision making body is the shareholders' meeting in which all shareholders may participate and in which decisions are made by majority vote. The

shareholders' meeting elects the members of the board of directors, which manage the company's operative management. The board of directors may choose the company CEO. The CEO's task is to manage the company in accordance with the instructions and orders of the board. (Mähönen et al., 2006, 84.) The management of the company shall act with due care and promote the interests of the company. (the Companies Act 1: 8). The company's management includes members of the board, and CEO.

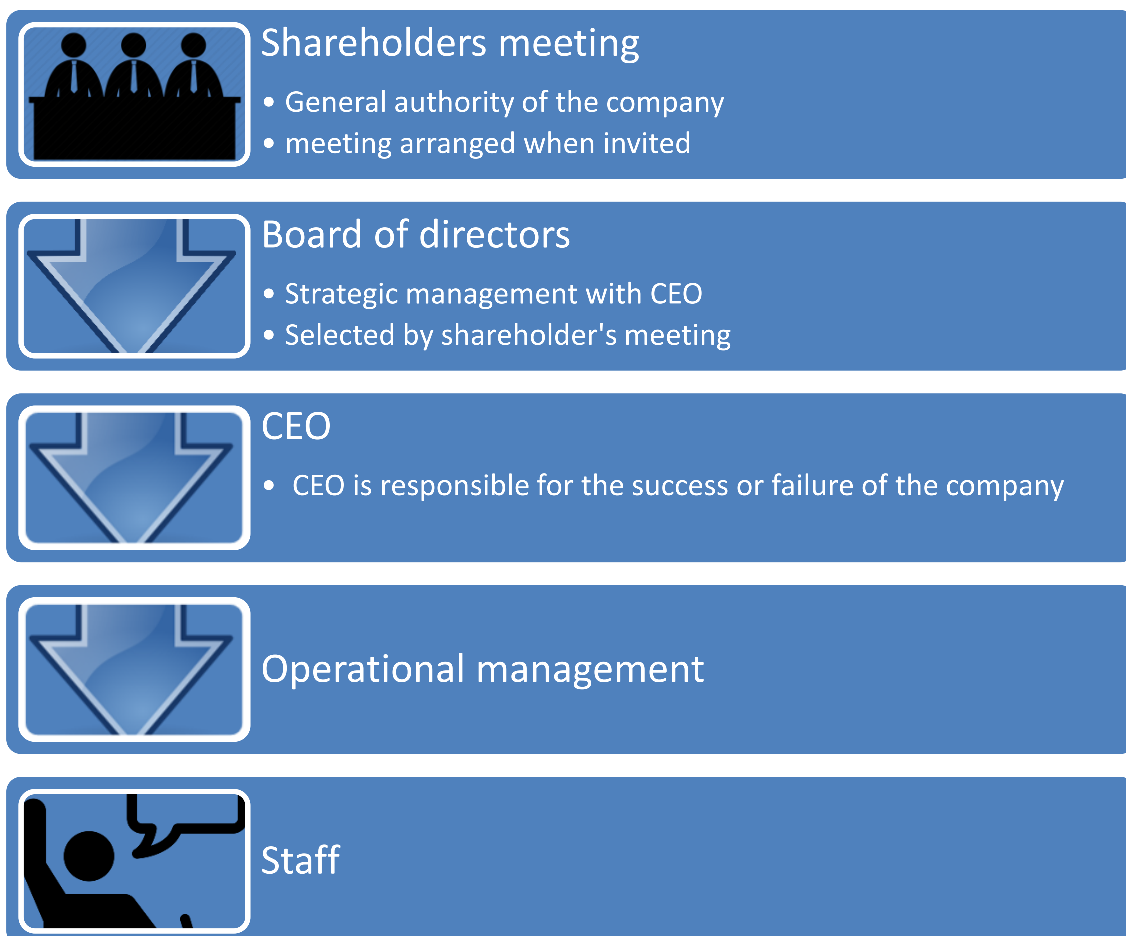

FIGURE 3. Decision making in a limited liability company

The purpose of a company is to generate profits for the shareholders, unless otherwise provided in the Articles of Association. (the Companies Act 1: 5). This provision means that the company's profit can be viewed in the long term. This allows different investments, such as the company's machinery and equipment renewal, product development and personnel training. This way the company may improve its ability to increase profitability.

The shareholders' agreement is an agreement between the shareholders of the company about how to manage the company and the company's affairs. The shareholders' agreement is not required by the Companies Act, and therefore it is covered by the general contract law principles. However, the shareholders' agreement cannot be in violation with the Companies Act. The shareholders' agreement is made either during the formation of the company or later when the company is operational. The shareholders' agreement is binding only between shareholders and it does not bind the company unless the company is specifically one of the counterparts of the agreement.

Shareholders are not personally liable for the company's debts but on the other hand they do not own the property which is in a limited liability company's balance sheet. When the company produces the profit the value shares will increase. Value of the shares is constantly changing depending on company profit or loss. The share value is also affected by decision of the company; will the company share the profits to shareholders as dividends or will it keep the profit as shareholders' equity. The share value is also affected if the company redeems its own shares or reduces its share capital. Shareholders jointly own the equity of the company, but the company is owned by a balance sheet of assets. (Siikarla 2006, 54).

From the legal point of view those who have invested to company equity are the owners of the company, which is crucial for the terms of sharing of profits and the repayment of investments. Those will be the last order of priority. (Sutinen & Viklund 2005, 99.) In practice this means that those who have invested to company as share owners will be in the worst position when sharing the profit or if the company needs to be closed. This means that the investment return will be paid only from the distributable assets of the company and in the bankruptcy situation, a ranking position is the last one. (Mähönen et al., 2006, 58.)

3 FINANCING THE COMPANY

Basically, the business is simple - investments are made based on the assumption that they will produce more than their financing cost money. This investment generates added value for investors. If the company is unable to make profitable investments, it produces a loss and its existence in the long term is not justified. (Ikäheimo et al., 2011, 144.)

The company needs a strong capital structure, which means that equity capital is relative bigger than liabilities. By having the strong equity, the company protects against the weaker results of the company. The financing of the company is in good standing when the equity is adequate in relation to a foreign capital, long-term investments and the company's working capital is covered by long-term debt financing, as well as short-term needs are covered by short-term funding. (Sutinen & Viklund 2005, 99, 106.)

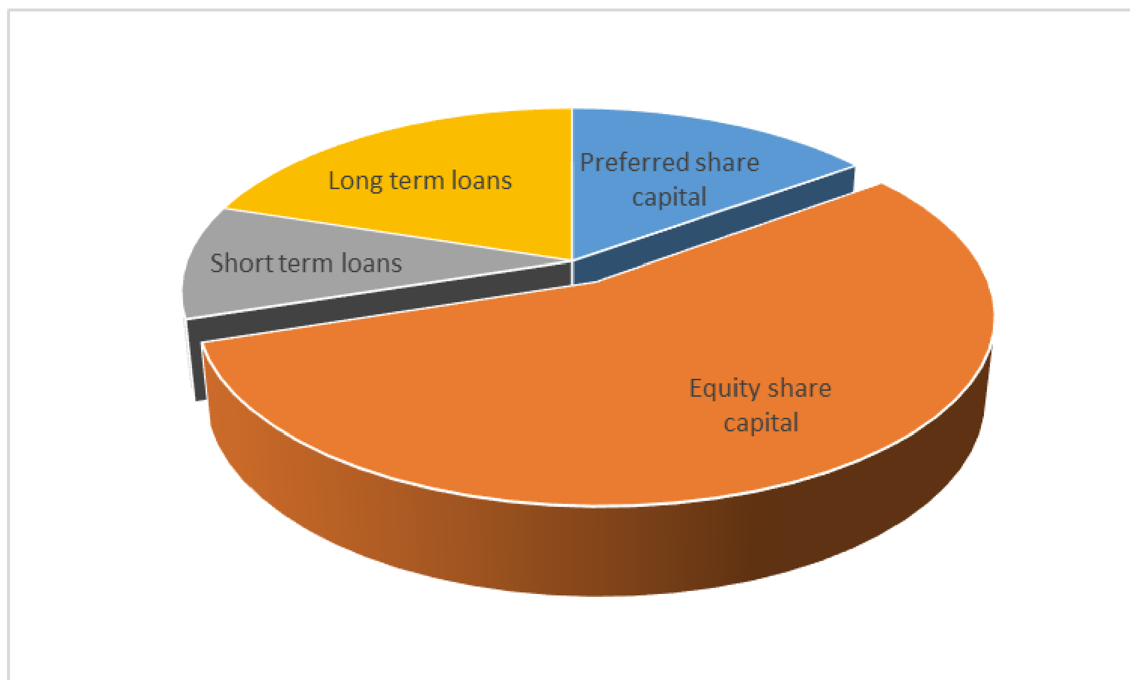

FIGURE 4 Example of capital structure

Ideally the investment should be financed by long term financing, for example by taking account the amount of the share capital when establishing the company,

subordinated loan from company owners or long term loan. Usually external investors require that the company owners are committed to company by financing the company by 20-30%. At the beginning the necessary investments can be financed by loans granted by public authorities, for example, by Finnvera's loans and guarantees, and apply for grants and subsidies, for example from the ELY -center.

About less 50% of the small and medium-sized enterprises have a loan from financial institutions. (Suomen Yrittäjät Ry & Finnvera Oyj 2017, 27). As a condition of obtaining a bank loan is usually always guarantee secured by real collateral (Hautala, 2000, 64). At 2009 less than half of the SMEs who have taken the bank loan the collateral is private property (Real estate for 27% of respondents) (Suomen Yrittäjät Ry & Finnvera Oyj 2009, 34, 39).

The collateral could be, for example, industrial real estate owned by the company or a holiday apartment. Very seldom the banks accept home as collateral for loans. The value of the collateral is always determined by the lender, and the value is determined according to the market values which may vary greatly. (Holopainen, 2011, 120.)

The problem for startup companies at the early stages (prior growth stage) is the lack of collaterals and the small size of own equity (Hautala 2000, 64). Also, the liabilities have obligation to pay interests and pay back the loaned fund. This will slow down the growth and may give the competitive advantage to the competitors (Lauriala 2004, 101.). If the company ends to problems and is incapable to pay the loan and interests the financier may apply to the company’s bankruptcy. Very often the only available funding is foreign capital investment. (Wasserman 2012, 251-253.)

The companies have possibilities to arrange the company's machinery and equipment acquisition financing through a finance lease. The finance company will buy the equipment and leases it by long-term lease to the company. (Holopainen 2011, 10.) This way the company does not need to pay full investment sum when upon order but on the other hand finance company will add their commission on top of lease payments.

Also, the installment credits are possibilities for the company. In these agreements, the purchases will be owned by the company and used as collateral for the credit. This way the company does not need to use other collaterals which may be needed for instance bank loans. (Holopainen 2011, 120.)

There are major differences in structures of companies' capital, depending on the industry the company operates. The services sector, where capital is tied more; the amount of the equity capital of the firm is an average of 60-70%. At the industry sector the equity may be as low as 30%, while the commercial sector, where the fluctuations are big, the equity can be 5-50% of the company capital and the wholesale market is usually 20-30%. According to the financial practices in Europe the companies whose debt's share of the equity capital exceeds 75% should not be financed. (Sutinen & Viklund 2005, 98-100).

The unlisted companies do not have universally applicable formula regarding to capital structure, but it should be tailored to each case separately. The size of the company, the balance sheet structure, its profitability and its industry and cyclical fluctuations affects to decisions. In general, the capital structure planning should enable the kind of financial flexibility, with the capability to ensure the smooth operation of the company's real processes. Financial flexibility of the company reduces financial risk and it is also a competitive advantage. If the acquisition of funding is not a problem, then the company could participate demanding investments or projects when competitors do not have the opportunity. Financial flexibility also describes a strong capital structure, which protects against the rapid deterioration of the profitability or the market situation changes. (Brealey et al., 2007, 465).

The company's capital can be divided into two types, equity and liabilities. (Lauriala 2004, 101.) The equity, can be divided into external and internal equity. (Knüpfer and Puttonen 2012, 29.)

Shareholders' equity is the money invested by owners of the company. Foreign capital is a loan the company has taken from third parties, usually a bank or other financial institution. External equity is invested by the owners of company (by marking the shares or by making a private investment). (Knüpfer and Puttonen

2012, 29.) The internal equity is the income that is derived from operating profit. (Knüpfer and Puttonen 2012, 30.) This also includes the shareholders' equity, because initial investments by the owners (external equity) establishes an income financing.

A profitable company finances its operations mainly from cash flow. The company may also finance the operations by managing the cash flows and taxation, doing investments (e.g. saving account), using credit card or credit account or by optimizing the trade receivables and trade payables payment terms. (Benjamin & Margulis 2005, 81, Leppiniemi 2009).

The advantages of capital investment in other financial income is that it is basically available in all areas of acting and for companies which are in different stages of development. (Suomen pääomasijoitusyhdistys Ry 2017.)

The capital investment is best suited for businesses with high growth potential and targets. New high technology growth companies are in favor of investment firms. They often need to do expensive investments at the early stages which require high-risk financing, even when no guarantees of a successful outcome can be given. The investments tolerate high risks but on the other hand they require a very high return on investment. (Hautala 2000, 61).

Crowdfunding

One rapidly increased and popular financing method is crowdfunding. Crowdfunding is a method of raising capital through the collective effort primarily online via crowdfunding platforms from the customers and individual investors. Typically, the individual amounts placed in crowdfunding are relatively small, but when having sufficiently large number of investors, even small individual amounts accumulates to the required volume of funding.

The progress of development of the Internet as well as the financial crisis boosted the interest in crowdfunding. In couple of last years, the crowdfunding markets have grown to huge billions of euros' business and it seems that growth will continue still. (VM0124:00/2013, 7.)

Even though the progress has been fast, it is still rather unstable and evolving field of finance. Also, attention to the regulation of crowdfunding has increased. In 2014, the European Commission set up an informal forum of experts, the European Crowdfunding Stakeholder Forum (ECSF), the purpose of which is to assist the commission in the development of a crowdfunding practices and to promote the exchange of information between the commission, member states and crowdfunding actors. The regulation of the crowdfunding in Finnish legislation came into force on 09.01.2016 (Crowdfunding Act 734/2016).

Equity crowdfunding (or investing crowd) offers possibilities for external funding to companies which are searching the finance their business, either as an alternative to traditional financing or parallel with utilization of traditional financing. Although equity crowdfunding seems to be quite undeveloped area in crowdfunding sector, it has significant opportunities to establish a position as one of the major forms of corporate finance.

In a simplified equity crowdfunding (i.e. share-based crowdfunding) the investor receives the company's shares as a return to financing and becomes company's shareholder. It differs from the initial public offering by the fact that shares acquired through a crowdfunding are not normally traded in the secondary market. (VM0124:00/2013, 5.)

When making the decision to use the crowdfunding the company's founding members should consider that by using the crowdfunding there can be formed a potentially very broad shareholder base which could create new challenges for the company's management. The founding members needs to define before participating the crowdfunding how company will be managed and how the crowdfunding will affect to the company's operations after funding. The Limited Liability Companies Act (2006 / 624) will give required freedom to the company to define the rules how to control the financial and management rights after the funding.

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FIGURE 5. Crowdfunding

The concept of crowdfunding is to seek financial support in advance for the project, so that the individuals can participate in the project by financing that. The crowdfunding is based on the collection of small amounts from many individuals, so that these individual cash flows accumulate the required amount of funding to implement the project.

The party which is searching the crowdfunding, presents the idea and project to public for finding the potential investors which may invest to project. The investors are group of individuals who decide to invest own money into project with expectation to get some return on their investment and knowing the potential risk of losing the money (Ordanini et al. 2011, 444–445.)

The key of crowdfunding is to utilize the internet and social platforms such as Facebook and Twitter. The effective communication can be considered as a key element for the success of a crowdfunding process.

One party in crowdfunding is the online crowdfunding platform. The purpose of the platform is to introduce the parties and allow easy interaction and communication between the parties. (Ordanini et al. 2011, 444–445.)

3.1 Capital investments

Equity investor types can be classified into three levels: wealthy private individuals, professionals which are searching for new investment opportunities and venture capital funds.

The capital investment refers to investment in small and medium-sized enterprises, which have a good development potential. In addition, the capital investor will bring added value for the company by involving in the creation of the company's strategies as a member of the board and business development using existing business network.

The business angels are also capital investors, but invest their capital in young growth companies. The business angels are private investors who invest their own money, and often also their own time and knowledge to the company. These investors are usually successful former entrepreneurs, who want to share their own knowledge and network in addition to the capital. (Lahti, 2008, 2.) The business angels make the most of their investments earlier than the venture capitalists. (Laukkanen 2007, 330.)

The business angels can unite as syndicates with other angels. The syndicate placement allows for a broader investment portfolio and lowers the industry risk because in syndicate it is easier to invest areas which are now so familiar. Joint investments make possible greater investments, because the individual investor's investment amount doesn’t have to be big but in together the sum could be significant. The angel investors can also make cross-investments together with private equity investors. (Etula 2014, 14.)

The investment can be done from the venture capital funds managed by venture capital company. The fund's assets are invested in several companies according to portfolio. In this way, the fund will reduce the risk associated with investments (Lauriala 2004, 22). The assets of the fund are collected from large institutional investors such as insurance and pension companies, banks and the public sector but also from the private individuals (Peltola 2007, 31). The company form of these funds is limited partnerships and they are set up a fixed term. During this period the value of the investment is expected to grow significantly. The fund's

lifetime is typically 10-13 years. During the first five years of the fund's assets will be invested in target companies. Even if the investment would be the done at last possible (fifth) year the company has time for another five years to develop. In some cases, the deadline for the fund has been going up and if the situation is looked bad, the extra time for the year was agreed with the fund investors. However, sooner or later the investment must be sold or liquidated by other means and the profit will be shared to the fund investors. (Lauriala 2004, 23).

The exits are very cyclical and highly depending on the economic situation. If the fund's lifetime ends in economic boom then it is much easier and profitable to make the exit compared to the recession.

The common investment done by business angel 20 000 € - 200 000 € (Lainema 2011, 50), and average investment about 60 000 € at 2012 (Finnvera 2013). The private equity investors investments vary a lot but usually between 100000€ up to 5 million euro. The investors tend to favor medium and large investments, because the costs of the investment process are not correlated with the size of the investment.

The capital investors can be categorized to three types based on the company types:

- Private equity - majority investments to mature companies
- The traditional capital investment - Minority investment to high growth potential companies
- Seed Financing – investment to seed-stage companies

The private equity investing is usually a majority investment to mature companies whose size in terms of turnover of tens of millions or more. The private equity investments will focus on companies which have stabile operations and cash flows and needs financing for the corporate acquisitions and expanding their business by high capital projects and reorganization of enterprises.

The traditional capital investment is the acquisition of minority shares in high-growth potential companies. In this case, the return is sought to significantly increase of company value and the exit.

The seed funding is investing to the start-up or newly established companies. The venture capitalists differ from the business angels in couple of ways, but most importantly for the sheer number of capital they have available to investment. Such risk investments are usually minority investments where the investor receives in return less than a 50% stake in the company (YritysHelsinki 2016, 20.) The target of the investment activities is to raise the value of the company by using investors professional ability and contacts. Usually this happens through board work, but sometimes even the participation of strategic management or operative management is required. When making the capital investment the investor takes the risk and hence the investment's expected return is significant.

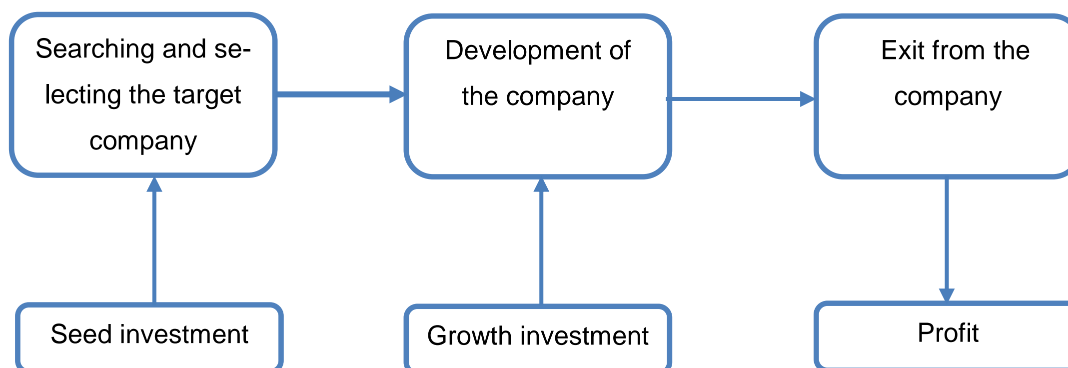

FIGURE 6. Risk investment process (Sutinen & Viklund 2005, 101).

As seen in figure the purpose of the investor is to develop the company with the goal getting maximized profit for invested funding.

The venture capital investments can be made in one or more installments. By sequencing the investments, the investor may control the target company's management and reduce the risk of the investment. (Lauriala 2004, 94-95.) It also forces company management to work more efficiently when knowing that next investment round is depending on their activities. In each round the investor can

determine the value of the target company again and set new conditions for the next financial rounds, or continue with the same terms. This way the investor can minimize the losses if the mistakes have been done in evaluation of the target company. (Lauriala 2004, 94-96.) If the investor refuses for further financing, it gives a negative signal to other potential financiers. (Lauriala 2004, 94-95.)

After the agreed period or in a suitable time the investor with exit the company. Suitable time usually is when the value of the company is at its highest, for example, when the target company is listed on the stock exchange, or is a good growth path and potential buyers are interested of the company. Investors tend to leave the company in an economic boom, because the successful exits are a good advertisement for the private equity company. That will benefit them when establish new funds. (Hautala 2000, 69; Lauriala 2004, 31-32.)

Due to fixed-term nature of capital investment both partners must have the mutual understanding of duration and the realization of the investment. The remaining lifetime of fund must be understood because the length of time will affect how quickly investor wants to realize profits, and it may again be reflected in the company's everyday life. If the entrepreneur and the investor's views are similar about the exit time, it increases the likelihood of successful co-operation until the end. (Pylkkänen 2008, 40-41.)

Also, the angel investor’s target is not to stay in a target company forever. On average, business angel exits the company after eight years (Lainema, 2011, 60).

The different stages of target company affect to exit planning. The company which is in later stage in lifecycle will get exits sooner than the company which were recently established. One reason is the asymmetric information; young companies cannot be determined at the beginning how they will develop and their activities are not as clear compared to older companies. For the older companies, it will be easier to schedule the exit.

The final trade takes weeks to one year. The entire transaction process including buyers searching and negotiations to the point when the money is in the account, it is long-lasting. It is not realistic to expect that to happen sooner than a year. Instead of targeting to some specific day the better timing perspective is half a

year. The fastest way to make the exit is to sale back to the founder. However, by doing so the investor will lose a lot of money because of low price and very often the founder does not get financing to acquire the share capital which cancels the sale.

Research made by FIBA shows that 10% of the investments succeeds very well, 40% of the investments the invested capital will be returned, and 50% of all investments will be lost. Since half of the investments will fail completely the investors will expect that successful investments will be extremely profitable. (FIBAN 2014.)

The investment strategy sets the objectives for the target company and the investment for a return. In addition, each venture capital fund has its own investment policy and profit targets. (Lauriala 2004, 32.) The average net yield varies based on industry, the development phase of the company and the economic situation but is expected to be annually 30-70%. The overall rate of return target of the fund is around 30 per cent increase in the value of the fund during the lifetime. (Hautala 2000, 64; Lauriala 2004, 22). Also, the investment instrument affects to the expected return. The capital investments are always expected a higher return than other investments, such as the direct investments of listed companies or real-estate investments (Lauriala 2004, 21).

Investors can earn money from the target company through at least four ways:

- Investor is usually one member of the board which are paid directors' fees.
- If the target company is managing well, it can pay a dividend to shareholders
- Investor is paid also an annual management fee.
- The biggest return on investment will come by successful exit (Lauriala 2004, 32, 34, 36.)

3.2 Financing instruments

According to the Companies Act, the company must have share capital. The minimum amount of the share capital is for private company 2500€ and for public company 80000€. (Companies Act 1:3, Capital and the permanence of the capital). The capital investment is marked to the shareholder's equity. The venture capital investments can be made as equity, in which case the equity investor becomes the owner of the company agreed stake. That also creates relationship between the investor and the company which is defined in Companies Act and in company's regulations. These rights and responsibilities will establish the corporate and financial relationship. (Mähönen et al., 2006, 97.) The equity financing is typically relative unsecured and cannot usually be shortened during the investment period. The equity financing of the venture capital investor is equal to the company's other shareholders. Only by the company's success the equity financier gets value for the investment.

The shareholder can also make gratuitous private equity investment which increases the value of the shareholder wealth. This investment is done without exchange of shares. The investment is based on an agreement between the company and the investor's. (Mähönen et al., 2006, 172-173.)

The private equity is counted as one of the company's source of funding. The private equity is typically most part equity, but are also characterized by different combinations of equity and debt. Other financial instruments are equity financial foreign capital consisting of various loans and debts. In addition, the company can use mezzanine financing instruments, which may include interest rate and the repayment obligation (Lauriala 2004, 128, 142.)

The capital investment improve the company's solvency (equity ratio) and adds confidence of stakeholders outside the company. For example, the company will get loans easier and loan terms are generally more favorable.

Equity financing can be arranged through a directed share issue to the equity investors. An investor subscribes new shares and become a shareholder in relation to the purchase of the total share position. (Lauriala, 2004, 100.) The share issue may be carried out also on their different voting rights in the shares, e.g.

20/1. The shares are in a different series, for example, A - and B - series shares. The investor is particularly interested in the voting shares, since they provide a relatively small number of shares a lot of the voting rights when deciding the company's affairs. The equity financing downside is the worst position in a bankruptcy situation. Shareholders will be paid on the last if there is anything to pay. Therefore, high returns are required for high risk investment. (Knüpfer and Puttonen 2012, 21.) The shares entitle to an annual dividend, if the company has not restricted shareholders' equity to pay them. Usually the dividends are used for company investments. Investors favor the increase of value of shares instead of dividend. (Lauriala, 2004, 101.)

The private equity investors have possibility to use a wide range of financial instruments. Commonly used in own equity instruments such as direct investment in shares or mezzanine financing instruments such as convertible loan and the preference share. Usually all instruments used by venture capital investors includes change rule; the instrument can be changed restricted shares. (Lauriala, 2004, 108.) The capital investor may also choose to use several different instruments at the same time.

Mezzanine financing means financing with characteristics of equity and debt. However, the financial instruments are not clearly neither. They are the bond loan, convertible bond, capital loan and the preference share. (Knüpfer and Puttonen 2012, 29.)

Convertible bonds (convertible note or convertible debt) are issued by the company and can be exchanged for shares of a company at a certain exchange ratio. When changing, the creditor waives interest and capital repayment, and becomes the company's shareholder. It differs from the bond loan so that the loan stock options and shares cannot be separated.

Capital loan can be equated with shareholders' equity; the loan can be shortened and interest paid if the restricted equity is fully covered. However, it does not have voting rights. In case of company dissolution or bankruptcy the capital loan is treated worse than all other creditors. Capital loan interest rate is between the

required rate of return of the liability and equity. The final rate of the loan is depended on conditions of the loan.

Preferred stock is the share without voting rights. it is part of shareholders' equity, but is more like debt financing. It will be paid a fixed return in the form of dividends, including interest on loans. The difference is that the payment of a dividend does not cause any contractual legal consequences. In addition, the dividend cannot be paid if the company does not have unrestricted shareholders' equity. Unpaid dividends will be paid on the following year and it will have preference for a dividend in relation to ordinary shares. (Knüpfer and Puttonen 2012, 29 – 32.)

The preferred stock has certain protective features that common stock does not have. Here are some typical features:

- **Liquidation preference**. This is usually defined in agreement with investor. If the corporation liquidates, for whatever reason, the preferred shareholders are in line before the common stockholders, but after the corporation's creditors. This means that certain investors receive their investment money back first before other company owners in the event the company is sold, has a public offering, pays dividends, or has another liquidation (exit) event.
- **Conversion option.** Holders of preferred shares typically have the right to convert their shares to common stock under certain circumstances.
- **Anti-dilution protection**. Preferred shares typically have antidilution protection which takes effect when the company issues share below the price that the purchaser of preferred stock paid.

The mezzanine financial instruments are characterized by the fact that they are in worse situation compared to bank loans in bankrupt but in a better position compared to the condition of the equity instruments. These are used for example when making investments to increase the company's own capital, which makes it possible to obtain a bank loan. The mezzanine financing is very often associated with a variety of option rights and the obligation to pay interest. (Peltola 2007,

31). Venture capitalists usually use individually tailored financial instruments that involve complex contractual arrangements (Lauriala 2004, 142-143).

If some part of the investment is a loan, then creditor can and usually sets some conditions for loans. When discussing about the startup company it is rare occasion that the company has any kind of collateral. The creditor will define covenant for minimizing the risk of investment. The covenant is a type of contract in which the covenanter makes a promise to a covenantee to do or not do some action. Usually the covenants will restrict the additional debt, and the payment of dividends. Negative pledge clauses (restricts giving securities to any other debt holder) are almost universal in unsecured commercial loan documents. The aim is to reduce the risk caused by opportunistic behavior of covenanter. (Brealey et al., 2011, 361.)

3.3 Added value to company

In investing terminology often mention the added value. Increased value can be measured for example by how much the value of the target company's shares has risen during the investment period (Lauriala 2004, 199 – 200.) Added value can be created either by organic operations by enhancing or growth, for example through acquisitions.

However, the investor could bring added value by many ways:

- Providing their own expertise to the company
- Wide range of contacts that can be used for company’s board of directors
- May acquire help to solve the company's problems
- Hiring a professional management to the company
- by being the company's management sparring partner and strategy challenger
- Providing funding for investments and acquisitions
- By acting as a neutral negotiating party in company acquisition situations
- Consult and advises for the expansion and internationalization related activities

- Optimizing the company's balance sheet and capital structure.

FIGURE 7. Added value for the company

The value creating begins even before the investor is involved to the company. In the company's evaluation process the investor will examine the company's resources and potential and possible drawbacks. Before that the company management has done preparations related to the company's status, problems, development opportunities and future objectives (Lauriala 2004, 199-200.)

The good investor brings an enormous amount of expertise and good networks for the target companies (Pylkkänen 2008, 40). Typically, investor invests in companies whose industry he knows well and has experience in the industry. (Lauri-

ala 2004, 27-28.). If the investor has no experience from the industry, or the contacts are from the wrong area, the network contacts does not bring any benefit to target company (Edelbacher et al., 2012, 363).

The professional management and the development of management systems are major factors in the development of the company because the management has the responsibility for implementing strategies (Peltola 2007, 32). The expert help may be acquired for the company's operational activities like development of the company's processes or develop marketing and budgeting. The board of professionals can be acquired to the target company. Usually board members have knowledge of various industries and the internationalization of the business, as well as expertise in the different areas.

In the best case the investor can participate in further financing if needed. Even if the investor is not able to participate in further financing, it can be very helpful when looking for further funding outside. The investor involvement is already a credit for the company and will convince venture capitalists more easily than if the company would not be involved in external funding agencies. Even the bank's attitude towards the company could become more positive when the company has professional owner. The business risk is shared with more parties, and the investor has assessed carefully the risks associated with the company and still invested in it. Also, investor may be experienced to find further financing. (Lainema 2011, 133-134.) In addition, the investor will use the contact network for additional funding planning and applying for acquisitions. (Hautala 2000, 64; Lauriala 2004, 200-201.)

The investors often play an important role in making acquisitions. Investor is often more neutral owner of the buyer's / seller's point of view. Usually investor has a solid experience in finance and business.

3.4 Challenges from investor's point of view

The investors' ability to cope with its own loans is the biggest challenge in the field. When the economy falters or interest rates rise, more and more of target

companies have tighter times with increasing investors' problems (The Economist 2009).

Because of the recession even the good investment companies may face the liquidity crisis when money runs out. Target companies value will not increase as expected or will collapse due to the recession. This leads to situation where the investments are longer tied to the target company and the availability of funding will deteriorate. The liquidation of private equity funds of liquidation will be postponed but the expiry of the deadlines may cause difficulties to Equity investors that forces them to make hasty decisions. At worst the investor's financial difficulties may lead to the exit of the target company for the wrong reasons. Before the financial crisis the private equity investors capitalized their purchases by taking more loans. This changed when the banks started to focus on saving and loan costs increased (The Economist 2009). Also, the venture capital funding has become more difficult because of institutional investors have reduced their share of investment funds.

The financial crisis has also brought different kind of challenges for companies operating in the private equity industry. The capital investment companies have been able to collect substantial amount of money to investment funds but the funds deadlines are coming and investors have difficulties to make new investments (The Economist 2009). During the financial crisis, the acquisitions will be difficult, because the market does not meet. The sellers keep prices up, and buyers focus on the maintaining of their own liquidity. Corporate values fluctuate, and make the conclusion of transactions difficult.

The private equity companies' activity in recession is also limited by the small size. This is especially a problem of Finnish investment companies. Bigger foreign investment companies will give funding easier and those have come more attractive for Finnish target companies.

The investors competences or lack of competence has been a problem. In more advanced countries like England or USA the investment has a long history with high competences but for instance in Finland the investors can be very inexperienced. (Pylkkänen 2008, 40–41.)

Selecting the target company can be very problematic. Before the investment the investor will study the company as well as possible but the information is never transparent and the contracts can not cover all the activities. Business includes always some risks. If the company has problems in sales or the costs will increase heavily compared to income, then the company will face problems and in worst case it will lead to bankruptcy. How the company has studied the risks and prepared the plans for mitigating or handling risks, how the deviations will be followed, what are the checkpoints when the decisions should be done? The investor will study the target company's risk strategy before the investment decisions. (Leppiniemi & Puttonen 2002, 193)

3.5 Finding capital investor

There are a variety of tactics for the companies how to act with investors. The existing product, cash flow, and customer contacts affect the value of company in the eyes of investors. Some companies will ensure that they have all three before contacting investors.

It is wise that the investor has worked in same industry as target company. The investor knows the problem areas and has already good network of contacts to provide. There are different types of investors and they work in different types of enterprises according to various criteria. The target company needs to define the criteria what they are looking for from the investor and to limit the application process only a few investors who meet the criteria.

The most important criteria when selecting of the investor are the target company's current stage of lifecycle, the target company's industry, the amount of needed funding, and target company's location. Each investor has their own criteria and company should not spend their time searching for the investor, which do not fit to the criteria for the company. (Pääomasijoitus – avain yrityksen kasvuun, 11-13.)

It is obvious that the investors will receive many applications from the companies. After initial clarification about 90% will be rejected. The investor will arrange meetings with potential companies where the both sides will study and discuss through the offering and needs from each side. After these discussions about half of the remaining companies will be dropped. (Hämäläinen 2001, 42–43.) Only less than 5% of those companies which have applied the funding will get investment. (Hautala 2000, 66; Hämäläinen 2001, 43). Hence the application should be send to several investors – if it does not fit to some investor's portfolio it can fit to someone else. (Hämäläinen 2001, 43). Also, two or more investors are better than only one – this way none of the investors will take over the decision-making authority in company. (Wasserman 2012, 295.)

Even if the company meets all the criteria for capital investment, the capital markets and general economic conditions affects to the investment amounts. During the recession, the investors are not capable to exit the portfolio companies as they have planned and hence the available capital for new capital investment is decreased. Also, the bad economic prospects discourage equity investors will to invest in high-risk companies. (Lauriala 2004, 31-32).

The changes and transformation of certain industries increases the attractiveness in investors' minds. For instance, the changes in regulations or rapid development of the used technology can be such changes. The development has been fast in information technology sector, telecommunications and Internet-related companies as well as in life-science industry. The medical industry is typically associated with high risks, but on the other hand a large potential for success. (Hautala 2000, 68; Lauriala 2004, 24–25.)

Because of the recession some investors are seeking target companies from the less cyclically sensitive sectors such as health care. In such sectors, the value of firms can be increase by improving efficiency and changing the corporate governance and operating models. Each industry has unique characteristics that affects to the target company's objectives, development schedules, the realization of the investment and business success in general (Lauriala 2004, 30). Globally the investors will invest to those companies that are aiming to growing markets where there is still the possibility to achieve high returns (The Economist 2009).

3.6 Issues investor will pay attention to before investments

There are no universal criteria for the investments and each investment will be evaluated case by case. However, there are clear criteria how the investors will evaluate the eligibility of the target companies, and the company's potential. (Lauriala 2004, 29)

Investors will only invest in those companies in which can be considered as true potential growth companies. They will evaluate the company's growth and development opportunities as well as the used technologies. Mature and low-risk technologies often fascinates the investors. More important than the technology itself is the usage of that; the cost savings for the customer caused by the product or competitive advantage which comes through the features and characteristics of the product are more important to the investors. Even though the technology could have defiencies the potential market and a clear demand for the target company's products may achieve an investment to company.

In addition, the key personnel in target company will be analyzed. The founding shareholders and the management team with experience and entrepreneurial spirit are very essential for the investors. The investor need to rely on the core team of the company and ability to create the sustainable business. (Lebret 2007, 79-87., Sudek 2007.) Management must know the target market and the competition in market. Also, the management must be committed to the development of company. (Hautala 2000, 66., Lauriala 2004, 29-31.)

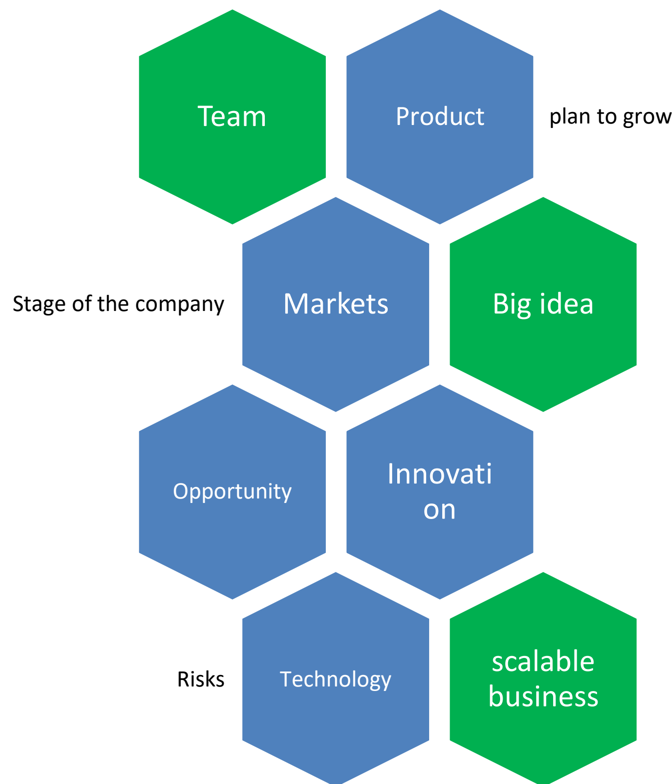

FIGURE 8. Investor focus points

Investors believe that the innovative companies are the basis for the successful business. If the company have innovative and encouraging culture it will get more investments and is capable for hiring better talents into company. The innovation culture means that the organizations will support the innovation in all means; all will commit to common goal, individuals and teams have high confidence level, mistakes are tolerated and are also considered as a part learning experiences. Innovation culture is built easily in an interactive company where the interaction is both formal and informal. (Apilo et all. 2007). The creation of an innovation culture takes place in the company by accepting different people in different points of view and by involving potential customers and other third parties to the development of the business ideas and this way to improve the original idea. The creative problem solving is the key for commercial success. Ideas should be testes in practice very quickly. By testing the concept quickly deficiencies and points of development will be better informed. (Solatie 2009, 73-81, Apilo et al 2007).

The most common criteria and the areas which investors want to clarify are:

- Background and experience of the founders

- Management team and personnel

- The target company technologies

- Understanding the market and the business plan

- Product

- Penetration i.e. market access

- Capital markets and economic trends

Many times, the most important investment criteria is the core team of the company. According to Kauppalehti even the mediocre business idea could get financing if the core team is top of the class. Investors will evaluate the team and individuals as a part of the team. The characteristics what investors will value are: ability to listen and learn, industry experience, clear and coherent vision about the future, motivation and passion, diversity, the ability to attract partners, team spirit, commitment, leadership and flexibility (Öhrnberg 2014.)

According to Etula the team can be evaluated through eight separate characteristics: mental strength, capability, knowledge, courage, networking, selling spirit, coaching, reliability and heterogenic. (Etula 2014, 33.) Very seldom the single entrepreneur has all the characteristics which are required from the optimal team. That is why investors do not usually invest to one man companies (Etula 2014, 35.)

Most small or medium size companies does not have the needed management experience or knowledge which is required for grow (Pylkkänen 2008, 40). They are usually lacking sales and marketing competences as well as development and training for the human resources.

From investors point of view, it is important that core team has required characteristics and if some of those are insufficient then there needs to be plan how to improve those. It is quite common that investor will require professional management to be hired as a condition for investment.

One important characteristic is also that people will get along with the investor – it will be a long relationship with the investor and hence it is important that collaboration will be smooth and beneficial.

The good and well prepared business plan is excellent tool when approaching investors but also it is beneficial for the company. When creating the solid business plan, it forces the management to think the answers to many questions and that way to prepare the company to avoid many problematic situations in advance before those are realized.

Usually the investors want to know how the company will operate. The business plan will have all the essential information about how the company will operate, who the customers are, what are the target markets and competition, and how the company will be developed in future (Ruuska et al., 1996, 4-6.)

Very often the business plans are based on history of similar kind of companies or products. This is the way to convince the investors that product or company is worth for investment (Ries 2011, 81-82.)

The content of the business plan is normally at least

- The assessment of the company's starting point
- The market and competition situation assessment
- The objectives and the business strategy
- The way in which the company has restructured its operations and development plans
- The economic calculations
- The assessment of risks and opportunities.

All parts in business plan should be compatible and the whole story must work together. The plan does not have to be a revolutionary or unique or even new. The most important thing is that it works. The company may have many business ideas. In this case, it is good to keep those separate from each other in order to monitor the profitability of the components and functionality at all. (Johnsson et al 1995, 13-14., Puustinen, 2004, 41.) It is essential to know at the beginning who

will do what and why. Knowing the markets and customers in a sense that company knows what customers need and what are the expectations from the product is the most important. That will set the short term and long term targets for the company (Puustinen 2004, 47 - 48.)

It is very valuable that the company have something to protect by intelligent property rights. The patents are particularly appreciated by the investors. When the company is looking for the first investor it is important that the monetary value of the patent is assessed as well as possible. The main parameters of a patent valuation are royalty rate, savings arising during the term of the patent and the degree of capitalization (Pöltner et al., 2009.)

The most important rights are related to the company's trade name and domain names, trademarks, design rights, utility models, patents and copyrights. The target company must own the critical IPR rights, which does not infringe the rights of third parties, and that the rights are transferable. The infringement of intangible rights may in worst case lead to usage ban and liabilities. (Hynynen 2012, 7)

The business idea can be fascinating from investors point of view but if the company has product or service already available for the markets then that excites investors. To sell the service or the product that needs to be productized. Without the productization the marketing and sales is much more difficult than necessary. Productization need to be understood as the company's internal processes, what it is not necessary to advertise separately to the customer. On the other hand, would be important to create each customer the impression that it was he who gets a unique service. It would be important to create a concept that would be unworthy of comparison with potential competitors. (Ilmoniemi et al., 2009.)

A promising idea needs to be productized as quickly as possible, so that the company can become more successful. It is essential that company will create the first product or service version as soon as possible which can be used for testing the markets assumptions (Ries 2011, 80-81.)

Just as important as the idea of the product or service is the development of the implementation method of the product. The implementation of the basic idea needs to combine product design, manufacture, sales and delivery to unique

seamless process. The result is a good and efficient business model. Experimenting innovation based model is rarer than other models such as the stage-gate, flash development and agile R & D models up to more innovation-intensive sectors. (Tuulenmäki & Välikangas 2011.)

Most of the companies have plans to grow their business and increase sales and profits. The good growth strategy will help the company to reach out the investors. The purpose of the growth strategy is to demonstrate to investors that the company has understood the needs of the market and is developing the technology based on market requirements. It is designed to help management understand which part of the technologies are critical, which parts have gaps and where to invest resources.

Companies usually try to maintain a steady and controlled growth. The growth management is very important for fast growing companies and the rapid and strong growth does not always lead to the desired outcome. The company's growth strategy identifies potential ways and means of the company's growth. The organic growth could be growth in business and revenues by investments and recruitments. Other ways are the company's growth by fusions, company acquisitions, innovation-based growth as well as networking. (Simons & Hyötyläinen, 2009, 131-132.)

3.7 Valuation of the company

The value of the company is always very subjective and the company’s value is different for different investors and it may also be different for investor and the company. The value should not be confused with price which is quantity agreed between the investor and the company after negotiations during investment process (Bäck et al., 2009, 120-121).

FIGURE 9. Valuation of the company

As corporate finance theory explains, the economic value of any investment is determined by the sum of the discounted value of its future cash flows (Brealey, Myers and Allen 2011). If the start-up company has only one idea that constitutes an investment plan it can be concluded that the investment valuation is valuation for the whole company. The business plan of the company is being valued. This kind of valuation depends on the ability to generate future cash flows and investors' assessments of the risk of these future cash flows.

There are many methods which are used for the determination of the valuation of the startup company: discounted cash flow, earnings multiple, net asset, and venture capital method. However, none of these approaches is fully satisfactory for the new start-up companies. The problem in pure account type of valuations is related to lack of information. The startup companies have a short operating history, and hence accounting information is limited which makes the future cash flows difficult to estimate. Also, the information asymmetry between entrepreneur and potential investors is typically high. The traditional valuation models that estimate the value of a firm by discounting forecasted earnings or cash flows are usually not recommended in these contexts. The investors frequently faces the

companies whose current value must be estimated regardless that the reward lies in an insecure future. (Isaksson, 2016)

It is very difficult to valuate the technology startup firms by using traditional valuation methods. While trying to valuate technology-based young companies, traditional accounting based valuating methods have many limitations:

- Very few tangible asset and a great number of intangible assets provokes that static values that come up from accounting methods undervalue the organization.
- The lack of comparable companies complicates the usage of valuation multiples methods
- The inexistence of historical data makes difficult to find an adequate discount rate, a return rate, and a growth rate from a theoretical point of view.
- The difficulty of estimating volatility because of the great uncertainty associated to technology-based startup firms.

The comparable transaction value is one indicator of the value of the company. The market price may be regarded as similar trades executed and what are the open rates. The problem may be a lack of available data; similar companies may not have been sold or the reliable purchase price is not available.

The valuation calculations also depend on the purpose and phase of the company. For instance, if the entrepreneur is looking for the seed money the valuation is remarkable different than if the company is looking for the growth money for international breakthrough. Also, if the company needs to be valuated in case of inheritance and wills the valuation could be different.

The value is dependent on many different internal and external factors as illustrated in figure 10. These factors include trade situation, the size of the target company with variable shareholders, the timing of the economic cycle and market activity. The investor is generally not willing to pay the full potential of increase in value, but may end up paying on the premium value of the company. (Bäck et al. 2009, 120-121.)

FIGURE 10. Factors of the value (Bäck et al. 2009, 122.)

The startup valuation is a relative science, and not an exact one. Because in most cases the valuation will be done for something that may or may not happen in the future, there is a lot of room for assumptions and educated guesses. The current state evaluation through the due diligence process will give some value for the company. The final value will be determined together during investment process and as a result of negotiations (Bäck et al. 2009, 120-121.).

4 PROTECTING THE INVESTMENT

Before the investor invests a large amount of money and effort to company he will try to protect the investment by best possible ways. The ways vary a lot depending on the investors but here are few common ways how to do that.

In addition of the Articles of Association the company management can be organized and controlled by Shareholder’s agreement. The shareholders' agreement is usually an agreement between the shareholders of a limited liability company, which will be agreed on relations between the shareholders and their relationship with the company itself.

The company's shareholders may agree about the company's rules and the rights and duties as they see fit and to agree on the issues to which cannot be or does not want to be interfered in articles of association. (Pönkä 2008, 1, 54, Saarnilehto et al. 2012)

The shareholders' agreement may be included in the articles of association, so that it gets the legal binding nature for the company, but in this case the terms of a shareholders' agreement will be drawn up in the companies act subject to the regulation and the agreement may be amended only by amending the articles of association. (Pönkä 2008, 40–44)

The preparation and negotiations of the investment takes time. It is very common that it will take more than 6 months or longer. The investment process begins from an investor’s point of view when company takes a contact to investor. From target company’s point of view, the process has already started when drafting the business plan including the acquisition of foreign capital.

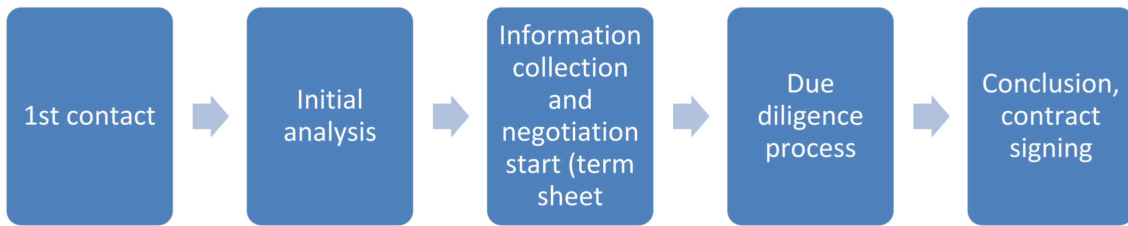

FIGURE 11: key milestones in investment process.

4.1 Due diligence process

The successful investment requires a comprehensive review and analysis of target company's business. The due diligence is an investigation of a business related to corporate risks and exposures. The purpose is to provide a clear and unbiased picture of the company's status in all aspects. The investor want to ensure that he knows the company that he is investing and what obligations it is assuming, the nature and extent of the target company's contingent liabilities, problematic contracts, litigation risks and intellectual property issues, and so forth. The due diligence investigation serves as a support of decision-making and based on the investment terms and conditions, and purchase price and structure. (Blomquist et al., 1997, 10., Katramo et al., 2011, 51.)

Through the due diligence process it is possible to examine in detail the various functions of the company. The extent of due diligence must always be suitable to the size and development phase of the company. Usually that is affected by the investor's expertise, the investment implementation mechanism, the probability of errors, the characteristics of the target company, the relationship of trust between the parties, the difficulty of the implementation of the inspection, the time available for checking and the cost of investigation. The content and extent of the due diligence review is determined by the combined effect of all the above-mentioned factors. (Bäck et al. 2009, 43). The inspection is expensive, so the investor will need to consider carefully what to check is carried out. (Lauriala, 2004, 56-57)

Before the actual due diligence process an investor and target company have reached agreement on the main terms of the investment and created the term sheet. A term sheet is a nonbinding agreement setting forth the basic terms and conditions under which an investment will be made. Term sheet fulfills two functions; It summarizes relevant economic and legal conditions as well as the quantified value of the investment. The most important issues are related to the value of the investment, the value of dividends and provisions of the share. Term sheet is also important for the target company, because the term sheet describes the conditions for the investment from the investor point of view. This gives the ground for contracts which can be made based on the term sheet. (Lauriala 2004, 55, 219-225)

The due diligence is an assurance for the high-quality and most risk-free investment, and very often the investment decision is likely, assuming that provided information was accurate and up to date. (Hannula & Kari 2007, 99-100.) During the process the company's most important and very business sensitive information is shared and hence both parties will apply the confidentiality agreement. (Bäck et al., 2009, 39-42., Katramo et al., 2011, 345)

The starting point is always the company’s business plan and other information provided to the investor. Before the written due diligence process the investor or a person authorized by investor will do different types of checks to get a good overview of the activities of the company and the industry as well as to ensure the competitiveness of the target company and explore the shareholders and company’s management and other key personnel experience.

During the due diligence process, the company representatives should be prepared to answer virtually all questions about the company. Key due diligence processes are in business, financial and legal due diligence. The target company will provide the reliable information and needed documents to investor and define the need for the investment. The investor will also use own network for gathering all important and essential information which are needed for decision making. In the case of a startup company, investor interest is usually focused on the leadership of the company and the product or technology commercialization and develop-

ment. After the checks the actual written due diligence process may start including a review of the same issues as in previous stages but further and more thoroughly. (Pääomasijoitus – avain yrityksen kasvuun 2006, 29).

Before the due diligence process the investor and target company may share the same valuation of the company, but on the investigations carried out during the due diligence process, the company's valuation may change in the investor's side, if the process is found the potential risks. (Lauriala 2004, 57-58.)

If something will be find out during the due diligence that affects the entire agreement, the entire investment process can be interrupted.

4.2 Representations and warranties

The information that has been given to investor is usually very unilateral and only given by company owners themselves. This may lead to situation that information is misleading or distorted. It is not rare situation that a founder would be asked to make a statement that the company's representations and warranties, as made by the company, are true and correct. This is the insurance representation as the founder would stand behind the full representations and warranties of the company and provide the investor with a breach of contract claim against the founder directly should any of the company representations or warranties turn out to be false. In addition, the founders' representations and warranties will typically also include representations and warranties specific to the personal, factual circumstances of the founder. These representations are generally limited to a narrow set of personal facts that are considered material to the investment decision. For example, the founder may be asked to represent that he or she is not violating any prior employment agreement, has never declared bankruptcy, or has never been convicted of a crime.

In investment contracts, the definitive agreement typically contains representations and warranties made by the company owners with respect to the target company. The representations and warranties not only provide information for both sides, but also operate to allocate risk as between investor and founders

with respect to the matters covered by the representations and warranties. Both parties are relying on each other to provide a true account of all information and supporting documents to close the agreement. The essential question from the contract point of view are the founders aware the given representations and warranties or should they be aware? (Katramo et al. 2011, 364 - 365.)

The most important representation and warranty is related to ownership of the company. The founder needs to show by the representations and warranties that he or she owns the shares in question and company doesn't have any unknown constrains. The founder must also ensure that he owns all the assets in the balance sheet. Constrains of small companies are usually transfer restrictions or repurchase rights. (Katramo et al. 2011, 367 - 368.)

Another important declaration from the founders relates to financial statements. The investor shall require from the founder's representations and warranties that the accounting principles have not been changed between the financial statements and are according to accounting law. (Katramo et al, 2011, 367 - 368.)

One important representations and warranties are related to the contracts. The contracts are important asset for the company and for the investor it is essential that he has reached all the necessary agreements and their contents. If some contracts cannot be shared to the investor due to secrecy, then the investor usually requests representations and warranties for those contracts that those agreements are generally no different to contracts used in the field. Furthermore, it is important for the investor to obtain a declaration that the contracts have no right to terminate the agreement or non-compete agreement in case of ownership change. (Katramo et al, 2011, 368 - 369.)

Also, the assurance that all the taxes and public charges are paid and company owners are responsible for those before the date of signature. This kind of tax-related issues can be disguised, for example, problems related to the distribution of dividends. At worst, it may result in large tax consequences for both the company and its previous owner. (Katramo et al, 2011, 369 - 370)

The representations and warranties usually continues for agreed time periods following the investment. Usually 12 to 24 months but at least the needed time for the taxation and accounting period.

The process of developing the representations and warranties can prove extremely valuable in the investor's diligence process. Any qualifications to the representations and warranties are listed in disclosure schedules that become an integral part of the closing documentation.

When negotiating the agreement, the target company has an incentive to keep its representations and warranties as narrowly drawn as possible; the investor, of course, wants those representations and warranties to be as open as possible. One way is to qualify the representations and warranties to its “knowledge”. A knowledge qualifier limits the reach of a contractual provision so that the provision only applies to what the relevant party “knows.” An investor prefers that the seller's representations and warranties are effective regardless of whether the seller had “knowledge” of the matter. In startup companies the investor can assume that company founders are aware of everything related to the company (Katramo et al. 2011, 365.)

4.3 Investment agreement, articles of association and shareholders' agreement

The companies act creates the basic framework for the company's operations. When the limited liability company will be established the founders will create written Memorandum of Association which must be accompanied by the articles of association. This must be done in accordance with the companies act and must not contain provisions contrary to the law. The articles of association contain provisions which shall be separated from the contracts. (Helminen 2006, 1, 9, 56.)

The articles of association is an agreement about how things should be managed in established company and it is prepared by the company's founding members. The articles of association gives orders for the general meeting, the board of directors and managing director and the auditors’ activities. These provisions on

articles of association also protect the outsiders of the company. They set the company's management to liability for damages unless management comply with the provisions. Each limited-liability company must have the articles of association. In general, the articles of associations are more detailed than what is required by law. (Mähönen et al., 2006, 64.)

The articles of association may be amended in the so-called majority decision, i.e. two-thirds majority of the votes cast and the shares represented at the general meeting. The articles of association comes into force and public once it has been entered in the trade register. After that the articles of association binds the company and its shareholders. (Immonen & Nuolimaa 2007, 50.)

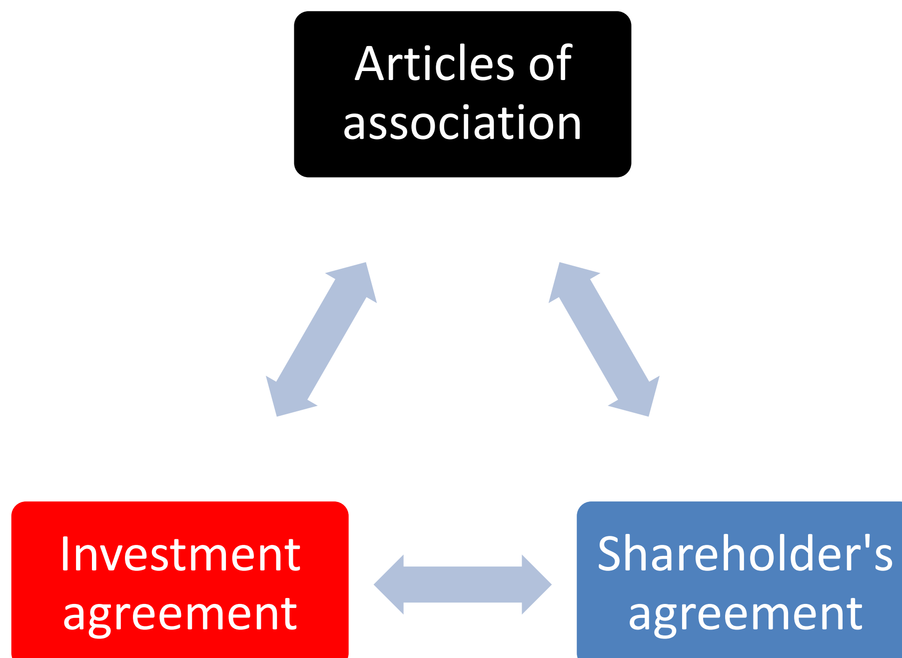

FIGURE 12. The agreements

According to companies act the share can be freely transferred and purchased if that is not limited in articles of associations. In articles of associations the founders may add redemption and consent clauses for protecting the changes in ownership and hence restrict the new parties to become owners of the company. (Immonen & Nuolimaa 2007, 62.)

The shareholders' agreement is an agreement between the contracting parties (usually owners of the company), which defines how they interact as the company's shareholders and / or members of the board of directors in the company. The shareholders' agreement is not a public document and the extent of the shareholders' agreement is not defined anywhere and it does not have to be linked to the company's articles of association or registration. The purpose of the agreement is to record the terms and responsibilities of the acquisition, in order to avoid misunderstandings and conflict situations. The shareholder agreements are binding only on the owners which have signed that agreement, while the orders articles of association concerns to all shareholders. There can be different types of shareholder agreements for various situations of mergers and acquisitions, company forms and corporate partnerships.

The shareholders' agreement is flexible and specifying contact, which can be added to any confidential terms and conditions, which are not to be included in the company's articles of association. The shareholder agreement can be considered to investor as a means of risk management. By detailed shareholder agreement the investor can secure the use of invested assets. (Lauriala 2004, 159-160.)

The shareholders agreement is not a universal standard contract which could be used identically to all companies. The shareholders' agreement is always tailored based on needs of the company and its shareholders. (Alho et al., 2009. 15–16.)

Also, the investment agreements are not universal. Usually the investment agreement begins with a term-sheet, which is non-binding document outlining the terms of a proposed deal. Once the terms are finalized, parties begin to exchange definitive agreements such as shareholder’s agreement and investment agreement. However, there is no exhaustive list available because all the investment and shareholder’s agreements are unique.

A typical investment agreement is a binding contract between sellers of shares (can be the company or its shareholders or both) and purchaser of shares, the incoming investor. It describes the terms of the investment, the amount of such

investment, and the amounts, timing and conditions of any future batches of investment. It will also define what the investor gets for as such investment (percentage of ownership, protections against dilution, etc.), and any additional rights (e.g. board representation). Other important point in agreement is the limitation of exchange of shares. (Villa 2006, p. 46-50)

The investor will also review, and could request the changes to the current agreements such as articles or association and existing shareholder's agreements. The investment agreement and shareholder's agreement, together are often combined into one document. In capital investment process the shareholders' agreement has a significant role. The investor will define the most important issues regarding to capital investment activity to the shareholder agreement. Through the shareholders' agreement the investor can guarantee himself the decision-making capability, so that the company does not get to make decisions which are harmful and damaging to the investor. Each party's rights and responsibilities should be accurately defined to the shareholder agreement in order to avoid conflict situation. (Hannula & Kari 2007, 50.)

The contract should include a chapter in which each contracting party shows that they are aware about the venture (or business plan) and are therefore aware of the company's business idea, goals and strategies. That agreement should also reflect the fact that each party has been carefully and independently evaluated the rights and duties of the shareholders' agreement and the risks and opportunities associated with the company. It is very common to include detailed development plan as a part of the agreement which is based on the company's business plan (Lauriala 2004, 31). In most cases the due diligence can be incorporated into the terms of a shareholders' agreement. (Hannula & Kari 2007, 13, 47-51.)

The shareholders' agreement may contain information about:

- Who are the parties and what is the background of the contract
- What are the objectives of the parties
- How the company will be controlled and what are the management responsibilities and insurances

- How the company's ownership and financing has been arranged before and after the investment and the possibility for further financing
- How the decisions will be made (unanimously, by a qualified majority or simple majority) and how to operate if unanimous decision is not possible
- How the share holdings are arranged (owner changes, liquidity of minority owner shares, etc.)
- the distribution of assets (dividend policy)
- Dilution terms
- How to affect to key person selection and salary terms and conditions
- the realization of ownership (the company exit)
- The parties' obligations, confidentiality, non-competition restrictions
- the validity of the contract
- Information sharing about the company confidential information.
- Sanction Terms

The various types of shareholder agreements can be drawn up at least the following: the entrepreneur partners, shareholders' agreement, a shareholder in the joint venture agreements, family companies, shareholder agreements, shareholder agreements mergers and acquisitions, and generational, a listed company shareholder agreements, as well as the venture capital process, the most important investor shareholder agreement. (Hannula & Kari 2007, 46.)

4.3.1 Shareholders' agreement parties

The shareholder agreement parties can be either all or only part of the company's shareholders. A party of the shareholders' agreement may also be outside of the company, a shareholder, the owner of the company, the company's creditor or someone who holds option rights or other special rights entitling to shares. In shareholder agreements is often agreed about relations with third parties, although the usually when the creditor is a party to the shareholders' agreement the creditor's right also includes the right to acquire shares in the company. (Alho et al., 2009, 16)

Also, majority and minority shareholders might have a separate shareholder agreements, if the shareholders are clearly divided on the number or types of shares. The company may be a party to an agreement which makes it generally more binding. For example, the breach of contract liability cases can also be extended to the company and very often this investor will require that company is included into shareholder's agreement. When the company becomes a contracting partner in the shareholder agreement, it requires a decision by either the general meeting or the board of directors. (Saarnilehto 1995, 181–188, Pönkä 2008, 280–290)

Usually the shareholders' agreement will be made for an indefinite period, as long as at least two shareholders are contracting parties. However, by the unanimous decision of the shareholders, the shareholders' agreement may be changed or terminated at any time. The fixed-term shareholder agreement is usually done only for unique and defined purpose or period. (Alho et al,. 2009, 17)

4.3.2 Decision making

The investor wants to support company business development and therefore increase of the value of shares by participating in the company's board of directors. This board work is the most important part of the collaboration with investor and the company (Pylkkänen, 2008, 41.)

Part of the investor's work in company's board of directors is usually recruiting talented people to the company and the development of management incentive plans. (Lauriala 2004, 200-201.) The target company's board of directors seeks to hire individuals who can add value to the company. The board of directors should be able to help the company's management and be consistent interlocutor. Their task is to comment on and assess the adequacy of resources and management competences in relation to the challenges posed by competition. The company founders should investigate the background of the members of the board proposed by the investor, and to give own proposals to members and to engage a professional person to board of directors' place for several years in the shareholder agreement. Appointment to the board members should be done as

carefully as the selection of the company's management team. (Pylkkänen, 2008, 41.)

The provisions relating to the composition of the board of directors is very often included in the shareholders' agreements because it is the interest of all parties. If the shareholders' agreement does not define the number of members of the board of directors then those will be defined by the articles of association, and after that the companies act. According to companies act, the board must have between one and five ordinary members. Usually the minimum and maximum number of members of the board of directors should be defined for ensuring that the company have the functional board of directors all the time.

The shareholders' agreement may also have the provisions for appointing the chairman of the board of directors. According to companies act, the chairman of the general meeting is elected by a majority vote and if the vote is a tie then the chairman shall decide. The shareholder agreement may provide that in case the votes are equal, the final decision is doing someone else instead of the chairman. (Alho et al., 2009, 76)

The board of directors will ensure that the company has a qualified CEO. The investor is usually a demanding owner and reacts more likely to the management poor results (Peltola 2007, 32). Chemistry between people greatly affect to the success of the cooperation between the board and the CEO, but the relationship between the chairman and the managing director is exceptional in the sense that the chairman of the board of directors must be prepared to terminate the CEO.

The most important decisions related to the company will be done in general meeting. The agreeing about voting in separate agreement is often seen as essential to the company's appropriate operation. The shareholders' agreement targeted for controlling the voting can be made to a certain general meeting, or only certain decisions of the general meeting. Investor want to make sure that no such things will be decided which are mentioned in shareholder's agreement without of the approval of investor. Such issues can be for example, changes to the articles of association, share capital increase or reduction, the redemption of own

shares, stock options issuance, amendment to number of board members, merger or division, placing the company into liquidation or applying for company reorganization, dissolution of the company, the sale or closure of the company's business. The investor may require a permanent power of attorney to represent itself in general meetings. Such power of attorney will give investors practically all the power to decide about the things mentioned above for example, the company's selling and additional capitalization. It is very common also that investor will request veto-right for certain decisions.

4.3.3 Controlling of ownership of the company

Some of the most essential things agreed in the shareholder agreement are the terms of control of the ownership and transfer of ownership. Investors usually want to control who can own shares in the company and how the shares can be sold.

The articles of association may set restrictions on the sale and transfer of shares further. The redemption clause can be set to limit a transfer of shares to a new owner and preventing a transfer of shares to outside the company. This clause is for preventing unwanted owners to become as the company's shareholders. The contents of the redemption right can be defined relatively freely to the articles of association and clause may relate to all shares of the company or only a certain type of shares. (Companies Act 3:7, Redemption clause)

The articles of association may also provide that the acquisition of shares by way of a transfer requires the approval by the company. A redemption clause does not in itself prevent shareholders selling shares but only give an opportunity to the person who is entitled to redeem the shares for himself. However, a consent clause can be considered to prevent the sale of shares relatively effectively. If the company refuses to give the permission, it seems likely that the shares cannot be sold at all. (Companies Act, 3:8, Consent clause) The company's board of directors must justify any refusal, so the refusal does not necessarily prevent the person to become as the company's shareholder. In this case, the rights of a

shareholder are limited because according to the law he cannot be entered company's share register without the approval of the company. He may not have all the shareholder rights, except to the extent that the right is exercised by the share certificate. If consent is refused without adequate justification, then the company may be sued and require the company's consent. The buyer may also transfer the shares forward unless the potential redemption clause prevent it.

The articles of association may provide that the company has the right or the obligation to acquire or redeem its own shares. For example, by using the terms and conditions imposed by the articles of association this makes possible fixed term investments. In this event, provisions shall be included in the articles of association on the following:

1) whether the matter is of acquisition or redemption;
2) whether the company has the right or the obligation to acquire or redeem;
3) which shares the provision concerns and, if necessary, in which order the shares are to be acquired or redeemed;
4) the procedure to be observed;
5) the consideration to be paid for the shares or the basis for the calculation of the consideration; and
6) the assets that can be used for the payment of the consideration.
   (Companies Act, chapter 15, Section 10, Terms of acquisition and redemption)

The redemption or acquisition terms in article of association will give to owner the known exit possibility, which may be a valuable for shareholder if the aftermarket opportunities are limited. In a private limited company the decision of redemption or acquisition can make the company's board of directors. (Companies Act, 15:10, Terms of acquisition and redemption)

In shareholders' agreement, the share transfer and exchange restriction can be agreed more widely. The restrictions on article of association are meant to limit a transfer of the company's shares to outsiders and by shareholder’s agreement the parties can regulate the company internal transfers between shareholders. A complete prohibition of transfer of shares is not possible in articles of association,

while the transfer clauses in the shareholders' agreement may prevent the shareholder to leave the company and new people to come as shareholders. In this way, the company's owner base and voting base remain unchangeable. (Pönkä 2008, 198–200.)

Since the shareholders' agreement is not legally binding the company it doesn’t prevent the shareholder marking to the shareholder register, even if the transfer of shares would be violation of the shareholders' agreement. Therefore, the shareholders' agreement to usually includes contractual penalty clause, which has been agreed because of a breach of contract. (Pönkä 2008, 200–202, 389–396)

The investors usually reserve the specific sale rights and obligations. A tag along provision gives a minority shareholder the right to have his shares bought on the same terms (and price) as majority shareholders. This clause is meant to protect minority shareholders from a buyer who might change the business to the detriment of the minority. (Lauriala, 2004, 185) For a tag along right can be connected to right of first refusal. Because of first refusal right the shareholders who do not want to sell their shares could purchase the shares sold.

A drag along (also known as a bring-along) provision forces a shareholder to sell his shares on the same terms as most shareholders who approve of the sale. (Alho et al., 2009, 118.) (Lauriala 2004, 184). These conditions reduce the risk of investment, and on the other hand may also increase the value of the company. These conditions for the sale of shares can be valid for the agreed period or as long as the shareholders' agreement is valid.

The investor may require that all parties agree in shareholder’s agreement that his approval is required for all the share transactions or transfers and that if someone is selling the shares then he has the right of first refusal with the agreed price. A properly shaped consent and redemption clauses will reinforce the functioning of the prohibition considerably. (Hannula & Kari 2007, 112)

The prohibition on transfer of shares can be circumvented through different collateral mechanisms, such as the pledge, if the matter is not prohibited by the

shareholders' agreement. For this reason, usually as a pair with transfer restrictions is almost without exception the ban to issue shares as collateral. Pledging of shares could lead to a situation where the realization of a pledge could lead to situation that shares could end up outside, even in the hands of a competitor. (Hannula & Kari 2007, 112.)

4.3.4 Company confidentiality and prohibition of competition

The investor usually checks the existing confidentiality and non-competition provisions on the shareholder agreement. Shareholders agreements typically includes shareholders personally imposing conditions such as confidentiality and non-compete provisions. The shareholder agreement should determine the compensation for a violation of the obligation (Alho et al., 2009, 118.)

Competition clause should be defined with sufficient accuracy that the non-competition works in practice and it does not change over time as unfair. The content of competition clause is restricted by contracts act fairness provision and general principles of law. (Contracts Act, 3:38)

Breach of the competition clause is usually strictly sanctioned. Related sanctions can be a substantial amount of contractual penalties, liability for caused damages as well as the obligation to transfer the shares at a nominal price to other shareholders or the company. (Hannula & Kari 2007, 139.)

The confidentiality clause in Shareholder agreements is to prevent the disclosure of the content of the agreement outsiders, as well as the disclosure of information concerning the company and its business, as well as owners. (Hannula & Kari 2007, 137.)

The shareholders' agreement confidentiality clause is a contractual obligation in nature, the violation of which causes contractual penalties. The infringement and misuse of corporate secrecy is also punishable under the criminal code. Also, the law Unfair Business Practices Act contains provisions on the protection of the business secret. However, it is justified to agree about the matters which are

cover by the legislation also in shareholder agreement. This way contractual penalties by the breach of a contract are often simpler and more effective than handling the issue in court only under applicable laws. (Alho et al., 2009, 138.)

A confidentiality clause in the shareholder agreement should also include exceptions. The exceptions are needed for example, in business transfer situation when the buyer usually wants to see the terms of the agreement. A confidentiality clause may include additional that the company's information can also be transferred with the consent of the board of directors.

4.3.5 Engagement of key people and incentive schemes

The investor wants to ensure that key employees of the company are committed to the company and its goals. The company's senior management is responsible for the implementation of the strategy in accordance with the development plan. Management abilities and desire play a key role in increasing the value of the company. For this reason, the investor uses usually a lot of time for assessment of the company's management skills when making the investment. Investor will influence to the Managements desire by ownership and incentives. The investor tries to engage the company's management for a period of investment by creating a financial interest in the company by means of share ownership. (Peltola 2007, 32.)

Ownership motivates the management and the company's success is equally Management and investor’s objective. Investment for management is always a genuine investment, not the option. The option holder has nothing to lose. Management holdings are generally tied to employment. A person is required to sell shares to investor, if the employee leaves or is required to leave the company.

When business develops, it is common especially in small businesses, that the company's key employees will be engaged to the company's operations at certain portion of shares, as in the form of incentive scheme. It is not necessary always to give the shares with voting rights, often ownership itself acts as an incentive.

There may also be an option contract model, which becomes to shareholders' agreement when personal (and / or company) objectives are met.

4.3.6 Distribution of dividends

The target company can distribute dividends during the investment period if the company's cash position and business development allows that and it is not prohibited in agreements. The payment of dividends can be prohibited on shareholder agreement until investor exits from the target company. The dividend may also be prohibited by the bank which is funding the company. Usually the bank insists that the commitments towards the bank have been treated completely before dividends may be paid. It is common that the parties of shareholders' agreement will agree to use the accrued earnings to the development of the company's operations and to refrain from profit and the distribution of funds for a fixed period. (Hannula & Kari 2007, 139.)

4.3.7 Breach of contract and sanctions

The breach of contract penalties are the most common things which are included in the shareholders' agreements. The breach of contract may follow, for example, liability for damages or a contractual penalty. Liability for damages and / or contractual penalty acts as a threat to a possible breach of the rules and thus violated party does not suffer any damage resulting from breach of contract.

The compensation of damages will be done according to Tort Liability Act (412/1974). In shareholder’s agreement, this will be done also according to the general legal principles of contract law, unless it is otherwise agreed. Breach of contract damages are usually very difficult to prove, so it makes sense to use a contractual penalty in the shareholder agreement. If the amount or maximum limit the contractual penalties are not included in the shareholder agreement, then the breach of contract party is obliged to pay the damages to the other party according to the general contract law principles.

The liability for damages can be restricted to in time or leaving some the terms of the contract out of scope of liability. The penalties could be different between the shareholders, depending on the position of shareholders in a company or whether it is a company or an individual. The purpose is not to be made in the contract violations and, therefore the contractual penalties must be on sufficient magnitude.

The contract penalties can be imposed so that the offending shareholder should pay the damage caused to shareholders, and to pay the full contract amount of the fine, either to the company or the shareholders. If the company is not a party in shareholder's agreement, then it cannot claim on the contractual penalty pursuant to the Agreement. The contractual penalties may not always be sufficient to cover even the costs incurred by the damage, so it makes sense to impose a contractual penalty in addition to compensation. The shareholder agreement can also be set compensation for damages and the contractual penalties in addition to the redemption provisions. Redemption orders mean that the offending party must sell their shares, either to other parties or to the target company. Any contractual penalty can be agreed to pay by transferring own shares. The shareholder agreement may agree on sanctions, which the shareholder loses the governance rights of shares. (Alho et al., 2009, 17.)

4.3.8 Anti-dilution protection

The dilution is defined as the relative reduction in the ownership percentage of a share of stock caused by the issuance of new equity instruments (such as the issue of shares). When the number of shares increases, the existing stockholder owns a smaller percentage of the company which makes each share less valuable. The dilution effect is increased if the new share subscription price of the instruments is lower than the previous rounds. (Lauriala 2004, 166)

The investors usually require anti-dilution protection for their investments. That protection is compensation (e.g. in the form of shares) if the next rounds valuation of the share is lower than the one in which the investor has come in. (Lauriala 2004, 165.) A variety of different anti-dilution protections exists. Protections differ

in how much will be compensated to the investor shares by the expense of other investors. Also, exceptions may be decided when the protection is not valid.

Although an investor may be diluted in the sense that it may own a smaller percentage of the company following any new stock issuance, the value of the portion of the company owned by such investor has theoretically increased due to the increase in the total company valuation due to the higher price per share paid by the new investor. Occasionally, absolute anti-dilution protection is requested by investors (or executives) against any dilution arising because of the subsequent sale of stock, which basically guarantees a certain percentage ownership of the company for a specified time or until the occurrence of a certain event, such as an initial public offering. However, these provisions may impair the company's ability to raise financing.

4.3.9 Redemption terms

If the founding partner wants to withdraw from the company, then the company has the right to purchase his shares at a certain price as agreed in redemption terms in shareholder's agreement. This is a very harsh method, because the shares will be paid rarely anywhere near the current market price. Usually this is softened by vesting arrangement, which means that during the certain periods of time the certain number of shares are released from redemption scope. (Lauriala 2004, 180-185)

The vesting arrangement can be defined as time or event basis, for example that a defined portion vests immediately or when certain period after the investment, and then as linear monthly basis. Some certain (and defined) specific milestones may also trigger the vesting. The founder vesting is always a matter of negotiation. The vesting can seem harsh and unfair, but investor will see it as important way of ensuring the founder is fully committed to the business after the investment.

The shareholders' agreement should include redemption terms for shareholder who has resigned or dismissed from the company and the outcome of those

terms is dependent on the reason the work has been terminated. The purpose of these terms is to provide an incentive to shareholders who work in the business to work hard and receive a share in the growth of the business when leaving and cashing-in (Good leaver) but also to prevent a shareholder who is important to the business from leaving before an agreed date or being guilty of some misconduct which might damage the business (Bad leaver). These provisions regulate the price that exiting shareholder will receive for his share. The price is usually heavily weighted in favor of a good Leaver (e.g. full open market value of his shares) and heavily discounted for a bad Leaver. (Carlsson et al., 2014, 117)

In shareholder's agreement, should be defined precisely the redemption process; who has the right to redeem the shares, at what price and terms, the number of shares to be redeemed and the redemption conditions of entitlement. (Alho et al., 2009, 128-136)

It is often the case that the definition of good leaver in shareholder agreements will include an employee and shareholder of a company who:

- Dies, or
- Becomes incapacitated through illness, or
- Is made redundant, or
- Is unfairly dismissed, or
- Voluntarily retires from employment after a pre-agreed period

The provision could give directors possibility to exercise their discretion to declare a leaver to be a good leaver and so provides flexibility. (Airaksinen 17).

Definitions of a bad leaver might include:

- Leaving voluntarily (other than retiring) to work elsewhere before expiry of a pre-agreed period, or
- Dismissal for gross misconduct or
- Dismissal which is not constructive or unfair

In many cases, such triggering events are extended and can involve very complex drafting to accommodate what the parties are prepared to agree. Whatever is agreed, it is very important that the drafting is clear and unambiguous to avoid any dispute over interpretation. This is a contentious area that requires great care and proper legal advice.

4.4 Exit strategy

The investors typically invest in to companies for 2-7 years prior to an exit event which means that the exit is roughly known already when investment agreement is signed. The common exit routes which are used by investors are initial public offering (IPO), acquisition, buybacks (in which the founders repurchase the investors shares), secondary sales (in which the investor sells to another investor but the founders do not sell), as well as liquidations. (Lauriala 2004, 199-200., Lahti 2008, 6.). If the investors preplan their exit, then the plan usually includes only as IPOs or acquisitions because the higher profit upon exit. The preplanned exit strategy is not part of the investment contract and hence it is not public information unless investor wants to share the information to founders.

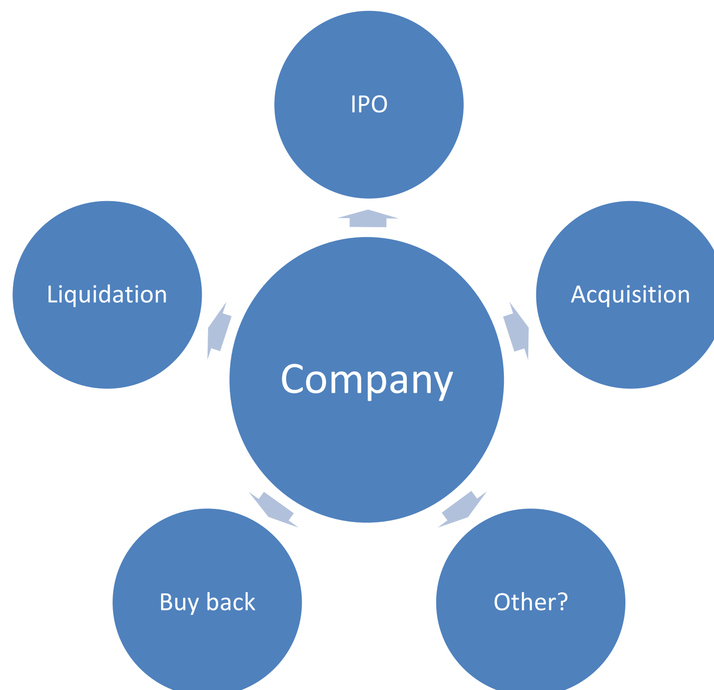

FIGURE 13. Exit options

The investor should have a clear plan for exit. It should define the holding period of the investment, exit route (usually IPO or a trade sale) and controlling methods for investment. However, according to Cumming and Johan's (2008) research only 19% of the IPO and 36% Trade sales was planned in advance.

The plan is not part of the contract, and does not need to present the target company's management. However, the mutual openness could affect the smoothness of the exit. If the investor is not willing to transparency, then the agreement need to include such a control means that suitable exit is possible. When investor has the comprehensive means to control the company then the value of the company is higher for potential buyer. Negotiations are easier because the buyer negotiates a single vendor, with the investor. The investor's participation is usually a guarantee of determined development process. (Cumming et al., 2008, 1210-1212.)

All activities that the investor does aims to successful exit from target company. The economic situation affects greatly for the profit. Investor tries to make the exit during the economic boom, in which case it is likely to get a better price than in recession. The right exit time is a major challenge. There is no one correct way for the exit because every investment period includes several uncertainties.

4.4.1 Stock exchange listing

The best exit route for investor is a stock market listing, initial public offering (IPO), which usually increases the value of the target company. This exit route gives an opportunity to collect a significant number of inexpensive financing for the company. The company may also use the shares as a payment of transactions. Usually investor does not do full exit immediately and instead he wants to wait until the value of the company has continued to grow. Also, investment banks which organizes the listing tends to require that investors commit to preserve some of their investment in the target company after the IPO, in order to maintain confidence in the target company. (Lauriala 2004, 201-203.)

Downsides of the listing are the high costs, market risk and, in some cases, the remaining as a company's co-owner and the associated restrictions on the sale of shares.

4.4.2 Acquisition

Another exit option is a sale of the company. In this case the shares are sold directly to an industrial or commercial buyer. The company sales have traditionally been the most common exit route, up to 32 per cent of the exits. The investor's point of view this is a good way because the payment is usually executed by cash or another liquid financial instrument. The benefits of acquisition are full exit, rather easy to arrange and the speed and affordability, since the company is sold to a single buyer. (Lauriala 2004, 210-211.)

4.4.3 Share buy back

The share buy-back means that the company itself or its management will purchase the shares from investor after the investment period. For making this possible the entrepreneur must have sufficient capital to purchase a large part of their company even after the increase in value. Usually this requires re-financing after the initial investment process and the investors shares are acquired by long-term institutional investor such as a bank or pension company. (Lauriala 2004, 200.)

4.4.4 Liquidation

Generally, the most avoidable option for the investor and entrepreneur is the company's liquidation and bankruptcy. There can be several reasons why the investment has failed. The target company could be chosen with wrong expectations and it will fail which leads to liquidation. Also, the return of invest could be in such low level that investor could not give additional investment which leads to liquidation. In some cases, the investment period is prolonged and that has caused the

unprofitable investment. However, this does not always lead to bankruptcy. (Lauriala 2004, 213-214.)

A write-off exit happens when the venture fails despite all the previous saving efforts of the startup's managers and venture capitalists. VCs then chooses to walk away from the investment by liquidating their holdings. In fact, write-offs lead to bankruptcy and the disappearance of many startup. (Cumming & MacIntosh, 2002)

4.4.5 Partial exit and secondary sales

The investor is always aiming to full exit with maximum possible profit. There can be certain situations when the partial exit is required.

A full exit for an IPO involves a sale of all the investor's holdings within one year of the IPO; a partial exit involves sale of only part of the holdings within that period. As earlier explained it is very common that investor does not do full exit at the time of IPO.

The case of partial acquisition exits is unique. In certain situations, the acquisition exit may resemble a partial exit. In acquisitions, depending on the degree of illiquidity of the acquirer's stock, the investor may be able to convert to cash only over a long period. Thus, the investor remains invested in the combined operations of its original investee firm and those of the acquirer. This type of transaction resembles a partial exit in that the investor's ability to influence and control the operations of the investee firm are reduced in relation to the investors reduction in equity ownership. It will not substantially decrease the investor's maintenance costs because such costs are relatively fixed and not related to a size of the investment. (Cumming et al., 2003, 516)

The partial exits will be made only in a small number of special situations, and in most of these situations, the purpose of the partial exit is to mitigate information asymmetries arising as between the investor as seller, and the outside buyer. The less the buyer candidate know about the company and its prospects, the

more conservative buyer will be the seller is trying to show the object of purchase in a positive light as possible. Investor also owns knowledge and skills which are relevant for the company in the future. The investor which continues as owner of the company brings credibility to the buyer and this will increase the value of the company. Information asymmetry correlates also to company's development stage; the earlier stage is more asymmetric than latter stages. (Cumming et al., 2003, 515)

The partial exit is a common route in young venture capital companies which are in a hurry to create reputation in a market, but still wants to keep some part of valuable company in them possesses for the future. The more the investment company collects new capital, the more they will do the partial exits. However, even this aims to achieve a higher value of final exit. (Cumming et al., 2003, 527)

In the case of a secondary sale, Investor may choose a partial exit to signal the quality of the firm and sell shares at a value closer to the firm's true value. However, acquirer will prefer to purchase 100% of the firm since it then has much greater freedom to operate without legal obligations to other owners. The downside for investor is that the value will go lower and control possibilities will dilute. (Cumming et al., 2003, 516). In addition, the secondary sales bring two previously unrelated owners of the firm together- the entrepreneur and the new owner. There is no guarantee that this relationship will work well.

A secondary sale will also typically involve sale of the investor's shares but not the entrepreneur's. This may be indicative of a breakdown in the relationship between the entrepreneur and investor. This is frequently associated with a lack of clear direction and purpose.

The investor's financial situation could force the secondary sales. In this case the secondary sales will be made to other investors. This will probably occur most often when investor's fund comes closer to the end of its life cycle and investments must be liquidated in an orderly fashion. This is clearly a scenario that the investor would prefer to avoid, since a forced sale may be down valued.

5 RESEARCH METHODOLOGY

This chapter explains the used research methodology. At the beginning reason why used method has been chosen is explained. Then, the actual research process is explained ending to data analysis. Finally, the reliability and validity of the research is evaluated.

5.1 Qualitative case study

This study starts by literatory study to understand the topic and phenomenon better. Compared to quantitative analysis, qualitative analysis is more explanatory in nature and this study aims to understand the start-up companies' founders when they connected with external funding, with an investor. Qualitative inquiry gives the interviewer possibility to focus on issues and to expand on the given responses to achieve a clear picture of the themes in question.

Studying of financing of the start-up companies is a challenging subject because of the nature of hidden and secret information. Hence, a qualitative study is best suited for data collection. The benefit of a qualitative study is that it aims to understand and gain insight into the subject (Ghauri & Gronhaug, 2005). The themes in this study was defined to capture the necessary information in the interviews.

5.2 Research methods

Series of interviews with startup founders were conducted. The questionnaire consisted of questions to determine the sources of finance and what kind of impact the financer brought to the company when he invested to the company.

The criteria for choosing the target companies was that they have acquired external funding and are at seed or early growth stage of lifecycle. Also, company form was limited liability company in each case.

A case study was chosen to describe the research problem. Personal interviews with representatives (founders) of the company were made. The themes were identified based on the theories and observations in the previous chapters. Based

on these themes a series of questions were asked from the founders to find out possible patterns or preferences in investment process or investors control mechanisms.

5.3 Semi-structured thematic interview

A semi-structured interview was considered as most suitable for this kind of research. This kind of interview allows for open conversational and two-way communication between the researcher and the interviewee. The researcher can keep the focus of the interview in desired direction and allow important aspects to arise within the subject. In a theme interview people bring forth their own experiences and opinions on the matter giving possibly a richer description of the phenomenon than a fixed questionnaire might. A thematic approach based on the theory chapters in this study was created to answer the research questions. Thematic analysis is used to encode the qualitative data and codes are used to label different words and phrases into recurring themes. The conclusions and generalizations can be easily made by the results, which was the target for this study. (Hirsjärvi et al, 2008, 208.)

The themes were chosen as follows:

1) Forms of financing
2) Capital investment
3) After investment
4) exit

More detailed description for the interviews for companies can be found in the appendices. The interviews lasted from 55 to 75 minutes at a time and were conducted during December 2016 and February 2017. The interviews were divided into themes by using a different set of code phrases and words. These themes included terms such as investment, financing, control, rules, management, added value, etc.

Themes used for the decoding of the interviews were the following:

- Financing in general – how the companies have financed their operations before the investor
- Investment process and its challenges – How companies found the investor and how the process went in practice
- After investment– what kind of restrictions the investor brought, how about the added value?
- Exit – was exit known from the beginning and how that was planned?

5.4 Data analysis

All the interviews were written down and the log files were transcribed by the author. This was done to both increase the reliability of the research and to help the author in identifying the themes that were present in the interviews. The transcripts were then analyzed by the author using themes to identify similarities and differences in the process.

The purpose of data analysis was to extract the information presented in the interviews and form an understanding of the themes in question. The transcribed interviews were coded into themes. After this the findings and themes were analyzed to create an understanding of the research problem. The themes are largely based on the theory literature present in this study and some themes raised from the interviews themselves. The interviews have been translated into English for this study. The author has translated the interviews himself.

5.5 Reliability and validity

The reliability and validity are often used to characterize and evaluation the relevance and trustworthiness of a research. The target of reliability for the study is to minimize biases and errors (Yin, 1994). There has been many research closely related to the research subject so comparing the results to historical analysis was partly possible. Also, the used methods in the study have been widely used in research and should provide a comprehensive analysis of the matter. Further, all the interviews were logged and transcribed for the credibility of the study.

The validity of this study compared to the theory is also a challenging due to reason that companies interviewed for the study are relatively new start-up companies. Also, only limited amount of companies was interviewed due to time constrains. This also might create bias in to analysis.

6 RESULTS AND INTERPRETATIONS

This chapter begins with an introduction and the background of the selected cases with key information. Then, it continues through the data that was collected from interviews with founders of the case companies. The main purpose of this chapter is to understand the venture capital investment process from target companies point of view. Both positive and negative opinions toward investment formation, development, and utilization are considered and analyzed.

6.1 Backgrounds of the companies

This subchapter introduces the background of each studied company. Rounds of financing, number of investors, and other financial investment alternatives involved are also described. This subchapter ends with a summary and comparison of the cases.

Company A is a SW development company which develops, and maintains solutions for limited markets (however the product can be easily transformed for global market and different services). Company A was established 2010. Plans to grow and be a global player in own area. Needed external finance for hiring new resources. Worked only with internal finance so far.

The founders began the discussions with investment firms for funding, and the process went smoothly up until the point of negotiation meetings with investment firms. The main reason for not having investor in the early stage of the company was an issue of control. The founders wanted to retain power over the company and control the company's direction by themselves. They did not want to face a situation where the company will be sold to externals or if they must buyout the investor or investor would withdraw funding and destroy the company. Company A manages to survive and grow through generating revenue, and is still active in the market today with 100-200K€ annual revenue.

Company B was founded 2010. Company B develops wireless training systems for animal training. They started as a spinoff of another startup company and they managed to create a first product with own expenses. Needed finance for the

getting talented team in place. Was looking for the investor and got 4 investors together with Finnvera's Avera. The Company B has received several investment rounds from several investors in starting at 2011. At the moment the company sells products in 15 countries and annual revenue between 100-350K€. Still every new development round require new investment round as well.

Company C provides web service for musicians. Company C was founded in 2012 and has been looking for financing through whole life time for ensuring its operations. Company C has received government funding from Tekes and from ELY. It has successfully raised funding from one investor and next investment round is about to come. Currently works as subcontractor for other companies for ensuring steady cash flow. Annual revenue between 10k€ to 50k€.

Company D was established to provide applications solutions for wireless devices. The company was established 8 years' prior first investment round and they had 25 employees working at that time. The reason for the investment was strategic decision for creating own product. Company D received over 3 million Euros from initial round at 2001. The company has raised multiple rounds of VC investment from multiple investors. Company D achieved exit via merger by a foreign applications solutions company for hardwire business in 2007. A multinational company then purchased the merged company in 2010.

Company E is founded in 2012 and develops, designs, and sales consumer's rapid testing products. From the beginning the company has known that the development of this kind of products consumes a lot of money and only way to get such money is external investor. The company has obtained seed capital and successfully raised venture capital. First product has been in test sale with positive results. Annual revenue at the moment is 10k€ to 100k€ but is expected to rise heavily.

All of these companies have participated into investment process. Only one, Company A has refused to continue the process and only, Company D, has made an exit.

The key elements that capture investment decisions to the case stories described by the founders are summarized and compared in Table 1.

TABLE 1. Summary of the key facts

	Company A	**Company B**	**Company C**	**Company D**	**Company E**
Year of establishment	2010	2010	2012	1992	2012
Year of receiving initial investment		2010	2013	2000	2014
Amount Received		Initial 70 K€, total unknown	Initial 70K€	Initial 3 000 000, total 20 000 000 €	Initial >100K€, total unknown
Rounds of investment	None	Several	1	6	2
Other funding received	No	TE office, ELY, Tekes,	ELY, Tekes, TE Office	Unknown	ELY, Tekes
Investor exit	No	No	No	2007	No
Operational area	Solutions for sports clubs.	Services for professional training	Consumer solution	High tech, chip vendors, phone manufacturers	Consumer rapid testing

6.2 Financing in general

This subchapter introduces the financial situation of each studied company before the investment.

All of these companies have requested and received governmental support and grants (TE office, ELY or Tekes etc.) in some forms except Company D which was unknown.

The need of funding has varied; Some of the companies needed finance for the daily operations until they managed to get cash inflow, some needed finance for the large-scale development and new technologies.

Company A choose to continue with steady growth by income instead of having external investor. This meant for them strategic re-planning what comes to growth. Companies B, C and E have received initial investments which were needed for covering the company's expenses until certain milestone is achieved. Company C and E does not have steady income and they need to have further investment rounds for continuing. Company B has steady income but when new development is needed then new investment round is needed as well.

Company D was rather big (and old) company when they got the first investors. They have worked as subcontractors in high tech area so far, they had the resources already and this was strategic decision to get more finance for creating own product. The company D is the only one which has done exit as well.

These companies accompanied with business angels and two with institutional vendor capitals (one got both). Three companies had more than one investor.

6.3 investment process– finding investor and steps forward

The companies were in different phases when contacting the investor. Three companies had a product available for demo (only one it was ready and use). Two of the companies had a steady cash flow before investment.

The companies reported that the items that investors looked in their companies were innovative product idea which can be scale to globally with good business case and the team behind the companies. The companies also reported that the team and market knowledge were very important from the investors point of view.

The initial contacting with the investor happened in most cases through the own social network and one through the Finnvera. One company used an agency for finding the investor in second round. All companies stressed own activity for finding one. Most of the companies (80%) contacted the initial investor

All the companies reported smooth investment negotiations. All the companies were well prepared for the initial investor meetings with solid pitching (pitching was stressed by all interviewed). The well-defined need for investment and plans how to use those were needed by all. Business plans as defined in theory were not needed. All companies had those but those were never reviewed thoroughly, only the need for investment and plans forward were handled more thoroughly. Although one interviewee said that the existing of the business plan is a mark for the good homework that investor will value.

All companies reported that when investment negotiations were active the only thing that they were after was money. None of those were looking for additional value that investor may bring along with money. Also, none of the investors had deep insight about the business where the company worked and none of the companies knew the investor thoroughly before the investment.

In each case the whole investment process for initial investment was rather short unlike the expectation of 6-12 months. The shortest negotiations had company D with 3 weeks including due diligence check (and they got 3 000 000 euro at that time.). The company founder admitted that the next investment round was more difficult. In average the investment negotiations took 2-3 months in total.

Company valuation in initial investment round was agreed by proposal from the company. All the investors approved that proposal.

The control mechanisms required by investor varied a lot. All investors reviewed the existing shareholder's agreement. Each company had the quite well covering shareholder's agreement already and only the Company D's shareholder's agreement was redefined after negotiations.

Only one company had the investor's veto right in important decisions.

All companies agreed to give board member position to investor.

6.4 After investment– Restrictions and added value

The investors typically acquire control in private or public companies. Usually the investor will use his expertise to implement the strategic improvements to increase profitability and add value to the business, which may include a combination of financial, governance and operational changes.

The investor will typically assume the board member position in company for controlling the company decisions and increasing the value of the company by strategic guidance. Also, agreeing about voting in separate agreement is one of the investors tools for controlling the decision making.

The investor might request the changes in operative level if seen needed. For instance, the investor may want to have CEO replaced by more experienced person. One of the company's CEOs was replaced by board of members after few years.

The reporting practices are related to members of the board meetings and agreements with investors. In interviews, the companies raised the issue that in their cases the investors were quite passive. Board meetings in a regular basis (4-6 weeks) but between those meetings the founders very seldom even heard about the investors. One company reported that investors were not seen in daily life but Investors were fighting with each other's.

One studied item was the added value for the company. The investor has many ways to give added value for the company such as own expertise and good networks. All the companies in this study reported that the investor brought only money and nothing else. The companies expected to get sparring partner but the investors were too busy to focus on their companies. Two companies said that the investors did not took the board member positions because of lack of time. None of the investors were participating the operational work.

" Good investor gave money and was totally silent after that"

" Even the board membership was not interesting enough"

" Maybe business angels would be bringing more added value?"

Three companies received more than one investment rounds. Later investment round was easier in a sense that new investors were trusting the initial investors opinions but every time the need of finance had to explain more and more thoroughly.

One reported that the stock arrangements were interesting because after several round of investment and after several different investors there were 4 different series of shares with different obligations.

Only one company said that the investors have a veto right for important decisions. None of the companies had agreements about voting.

Every company reported that all parties had same shareholder's agreement.

6.5 Exit planning

The successful exits require considerable planning and many actions from all counterparts involved to company. There are also many possibilities how the investor could do the exit and how the investor will ensure the success of the exit as well as possible through the agreements with founders.

The exit strategy is not a public information and it is up to investor whether to share that information for founders. However, the mutual openness could affect the smoothness of the exit. If the investor is not willing to transparency, then the agreement need to include such a control means that suitable exit is possible.

In these companies, only the company D knew that exit will happed some day and knew the rough schedule for that. That company was also the only one which were prepared for exit through the agreements.

None of other companies had any discussions about the exit or any exit related control means in their agreements.

7 DISCUSSION

This thesis focuses on the questions around start-up companies financing. The study searches how the investment process goes with the newly established companies, what are the reasons why the investors are financing those and how the collaboration with investor works in practice after the investment. In theory part the capital investment process was opened and investor's protection mechanisms were explained.

In empirical part the companies have been studied for understanding how the theory matches in these companies. The goal of this thesis was to study how the entrepreneurs felt the situation when the outsider financier comes to a part of the company and how that will affect to daily life of the company management.

Research question: *How the entrepreneurs felt the situation when the financier has strict rules which limited the freedom of operating.*

There have been many different methods explained how the investor can protect the investment. The study showed out that even though the investor could have all the power to define limitations and restrictions for the company operations for protecting the investment that was not the case in companies in case studies. The control was even surprisingly loose in general; most of the investors were not requesting any special terms to agreements and even all the investors were offered position as a member of the board, not all the investors even took that position.

The conclusion may be drawn that entrepreneurs felt that they still have a freedom to operate and run the company with their best interest.

Subquestions: *to understand the target company selection criteria, as well as the investment process from the perspective of a founder. In addition, the objective is to investigate the sources of finance and correlation to the business plans.*

At the beginning when talented and inspired people are establishing the company they usually have the bright idea for a business but very few money if nothing. That will be the challenge and the possibility for the company. The company must

survive with all the available resources and constantly seek funding for their needs. The funding is needed for turning the idea into something tangible.

The company founders will turn every stone for getting funding for the company; borrow from home and close ones, use the credit cards and take the personal loans from the banks if any collateral available. A lot of risk involved, including the risk of personal bankruptcy and soured relationships with friends and family.

Very close to that time the company will request and receive initial funding and grants from governmental organizations like TE center, ELY center and Tekes. Most of those are meant only for surviving and if meant for investment support then those require cash flow before those are paid because those are paid per actual costs incurred. This means the company must have money for paying the costs which they may get back afterwards, depending on the situation.

The company funding prior external investment was seen in theory and in interviews. All the companies have business plans and they planned the activities accordingly.

The initial operations ramp up as quickly as possible is essential. This the point when usually investor comes into picture. Only few businesses can be bootstrapped and built up quickly enough to make money without aid from investors. During the continuous surviving game when the founders should be able to create the service or product that will be sold, in parallel they must find the funding for the company. They will have a solid business plan and they will use all possible contacts for seeking potential investor. And if they are lucky they will find a good one.

When contacting the investor, the process starts; the company must have clear plans what they are doing, how they will use the money and what the investor will get for his investment.

In literature review it was expected that investment process will take a long time, 6 months or longer. This was not a case and in average the companies concluded the investment rounds in 2-3 months or earlier. Also, the business

plans were not reviewed thoroughly but only for understanding why the companies need money and how they are using that. Also, it was expected that investors will invest only to area they know – this was not seen in interviews. Actually, none of the investors knew the area that they commit to invest.

The companies reported that the items that investors looked in their companies were innovative product idea which can be scale to globally with good business case and the team behind the companies. The team was specially stressed by all as well as marked knowledge. This is very similar to theory as well.

7.1 Improvement proposals.

As all the companies reported during the investment process they were only looking money. Also, all companies reported that this was the only thing they got from the investors – this means that a lot of potential knowledge has not been use for improving the company value.

Also, all companies reported that their investors were quite passive. Maybe by using more time and effort on company's side for selecting the investor would be required. However, the investor is long term relationship for the company and hence the company should use time for choosing that.

7.2 Limitations to the study

The biggest limitation to this study is by far the possible bias in the data collection. The number of companies is moderate, which can bias the results. There are notable differences between companies but on the other hand some of the differences may hided due to small a number of companies and their similar answers. Hence, a larger sample of companies should be analyzed for next research.

Another limitation to this study is that it is made for Finnish companies and specially in Oulu region. This limits the research because the companies are only from same location and under same laws and regulations.

Also, as the answers to the theme interviews measure only the understanding and expressions of the participants, the results might be biased due to behavioral reasons. Yet again, this can be minimized by interviewing larger sample of companies which would normalize the results.

7.3 Future research

This kind of questionaries' should be done in future with much larger number of companies with different development stages. That is the way to get more reliable data and compare the companies in different phases. For future research the analysis and data from international sources would be valuable instead of only Finnish ones. The collection size would ideally be larger for more thorough analysis.

The study should be extended to cover also the crowdfunding for studying how the companies have prepared for the challenges in governance of the company with different kind of investment sources.

8 CONCLUSION

This master’s thesis focuses on the questions around start-up companies financing. This sector is going through a rapid evolving in Finland. Instead of having one big high-tech operator the industry is changing to a lead of large number of smaller new technology companies. This change has an impact to may fields, but also to the local economy in Oulu as well as Finnish economy overall. This change is not coming without support from financing sector, capital investors.

The study searches how the investment process goes with the newly established companies, what are the reasons why the investors are financing those and how the collaboration with investor works in practice after the investment. In theory part the capital investment process was opened and investor’s protection mechanisms were explained.

The empirical part of the study focuses on start-ups in Oulu region, in Finland. Oulu region have strong and viable technology culture because of long lasting big investment what Nokia and its collaborators have brought to region in past decades. During the last decade, the Nokia presence has been decreased but that has now been transformed to culture of entrepreneurships and startups.

For keeping this culture alive and evolving those companies needs capital investments.

What comes to title of this thesis “Do I need to sell my soul for the money?” No, you do not need -but instead you should sell your soul for the company.

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APPENDIX

Yrityksen tausta

- Toimiala

- yrityksen koko

- yrityksen rahoitus- ja kehitystarpeet

Rahoitusmuodot

Mitä rahoitusmuotoja yritys on hakenut/saanut

Mitä kokemuksia niistä on kertynyt?

Pääomasijoitustoiminta

- Mikä sai hakemaan pääomasijoitusta?

- Kokemuksia pääomasijoittajavaihtoehdoista

- Kokemuksia neuvotteluista, mistä asioista sijoittaja oli kiinnostunut?

- pääomasijoituksen muoto, määrä ja kesto

- yrityksen omistusrakenne ennen ja jälkeen sijoituksen

- jatkorahoitusmahdollisuudet

- Vaatiko sijoittaja muutoksia osakassopimuksiin

Pääomasijoituksen jälkeen

- mitä asioita pääomasijoittaja toi yritykseen (muutoksia)

- yritysjärjestelyiden hoito

- toiko pääomasijoittaja muuta kuin rahaa?

- mitä muuttui yrityksen toiminnassa pääomasijoituksen jälkeen?

- Päätöksentekomahdollisuudet ja niiden muuttuminen

- yhteydenpito sijoittajan kanssa

Irtautuminen

- irtautumiselle asetetut tavoitteet

o ajankohta ja irtautumismuoto

- yrityksen vaikutusmahdollisuudet uuden omistajan valintaan

- mitä muita irtautumisvaihtoehtoja harkittiin