Basics of Seed Funding In India
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If we delve into the statistics and business climate of India during the past few years, there is no doubt that the country has been riding an entrepreneurial wave. Indian start-ups have raised over USD 42 billion in funding capital over the past year~~,~~ making India the third-largest start-up ecosystem in the world[1]. Despite these recent developments, competition from other start-ups poses a difficult challenge for entrepreneurs in the preliminary stages of funding – in particular, seed funding.

What Is Seed Funding?

Seed funding is the preliminary stage of funding when the business is primarily a concept with the potential to grow. This stage is mainly about acquiring capital for product development and expansion – which helps in lifting things off the ground so that the business has a running start in its operations before earning the revenue to sustain itself.

The path to receiving such funding is not simple, however. Usually, the entrepreneur needs to assess criteria such as the type of investor, what funding scheme to pick, and whether or not it suits the nature of the company or its financial setup. Fortunately, in an entrepreneurial ecosystem such as India's, start-ups have multiple sponsorship sources to compare and assess. The three types of funding available for start-ups are equity funding, debt funding, and government grants[2]. Each option offers different advantages and the sources of funding under these vary. Investors that mostly opt for equity-for-capital returns are angel investors, venture capitalists, and incubators or accelerators.

On the other hand, sources that mainly specialise in debt financing are banks, revenue-based finance companies, P2P, and government loan schemes. However, this classification remains flexible as many of these sources have both equity and debt-based funding options.

Entrepreneurs thus need to identify the investors that best suit their needs. One of the most effective ways is to consider the stage at which the business presently stands. This helps in understanding the critical requirements of the business and recognizing the kind of investment plan needed to fulfil them. With respect to funding options suitable for the seed stage, the most common ones are explained below.

Basics of Seed Funding: Understanding Your Options

Angel investors: Angel investors are investors with significant experience[3] in providing capital during the early stages of a business, making it the most common source of funding for seed-stage start-ups. As per regulations introduced by the Securities and Exchange Board of India (SEBI) under the SEBI (Informal Guidance) Scheme, 2003[4] regarding angel funds that finance small start-ups, an entrepreneur needs to abide by certain requirements to be eligible to receive capital under such funding.

A major requirement to be eligible is the age of the start-up and if the turnover rate per year is less than twenty-five crores.[5] Angel funds allow start-ups to receive a minimum of twenty-five lakh rupees that can go up to five crores as capital. Considering that only 'accredited investors' can apply as angel investors, the entrepreneurs get additional benefits like less risk of default, no payback or interest, mentorship for the start-up, etc. This makes it an excellent option for early-stage financing if the company can dilute a significant percentage of its shares (usually 10-50%).

Crowdfunding: Start-ups can raise capital by inviting the public at large to invest in either online ventures or projects. Crowdfunding can be of various kinds[6] based on the type of return the investor gets in return for the capital provided. The return for investors can be product-based, service-based, or even nothing (donation crowdfunding), depending on the start-up's pitch.

Crowdfunding is a good option for seed-stage companies since it is more accessible and less expensive and the pitch also serves as a marketing tool. However, there is a lack of clarity in terms of the regulations concerning crowdfunding as a means to raise capital. To bridge this gap, SEBI has released a consultation paper that puts forth certain suggestions to make this area more uniform.

Peer-to-peer lending: As the name suggests, P2P is a debt-based funding mechanism. With a total of thirty start-up P2P lending companies in India, it is safe to say that it is a growing credit facility.[7] Based on a crowdfunding platform, P2P invites start-ups to set the interest rate and other related terms mutually with the lender. As is the case with other financial institutions, lenders in crowdfunding do a brief assessment of the start-up's status and creditworthiness.

Once approved, the borrowers pay an origination fee according to their risk category. One main advantage of P2P lending for borrowers has been the low rates of interest compared to those offered by money lenders/unorganized sector.[8]

To obtain P2P lending and other forms of crowdfunding, one needs to register the start-up on an online platform. The minimal documentation involved in P2P and different types of crowdfunding is also a factor that makes it an attractive choice.

Venture Capital funding (VC): A form of private equity financing that venture capital firms, venture capital provides to fund start-ups with high growth potential.[9] Unlike banks/Venture debt funds where lenders have a legal right to interest on a loan, the investors here invest in exchange for equity. To obtain Venture Capital financing, the entrepreneur needs to take the first step by pitching their business idea to the venture capitalist. It is said to be the deal origination or deal sourcing[10].

A deal can also be originated from the funder's side through referrals. It is followed by screening, evaluation, deal negotiation and creation of deal documents preceding the investment made by the investor and post-investment activities. Finally, the venture capitalist will opt for exit plans to ensure maximum profits and minimum losses and avoid legal liabilities, if any. Some exit options are IPOs, buyback of shares, the redemption of fully paid-up preference shares, etc. This stage, however, is ideally suited for start-ups that have achieved ’early traction’ or have had their product launched in the market.

Government schemes/Incubators: Incubators are organisations, teams, or platforms created to assist start-ups by providing services like mentoring, workspace, and funding. On January 21st 2021, the Department for Promotion of Industry and Internal Trade (DPIIT) officially released a notification introducing the Start-Up India Seed Fund Scheme (SISFS). The scheme recognises that funding from angel investors and VCs requires start-ups to show ‘proof of concept’[11] (POC) or creditworthiness of the business idea along with a viable need of the particular product in the market. However, due to a lack of proper resources, many start-ups fail to obtain POC. SISFS aims to resolve this shortcoming by providing seed funding to start-ups, assisting the businesses in developing ’proof of concept’ and their start-up.

Steps Towards Receiving The Funding You Need

Irrespective of the source of funding, it is observed that the entrepreneur has to follow specific steps to ensure funding. They are as follows:

- Assess the need and the readiness of the company before raising capital. It is especially important for angel investors and VCs as they do their due diligence about the start-up's history, transactions, and nature before investing.
- Get recognized by the Department for Promotion of Industry and Internal Trade (DPIIT) and be incorporated for a maximum of 2 years at the time of application.
- Get the company registered using Articles of Association, Memorandum of Association and a company valuation report by an accredited chartered accountant.
- Apply for all registrations under the tax regime.
- Protect the intellectual property rights of the product.
- Conduct a board meeting, and an extraordinary general meeting (for allotment of shares) to finalise upon funding.
- Prepare a detailed presentation about the start-up outlining all the important aspects[12] and the utility of the product. This should be done after having researched a suitable investor.
- Negotiate the final deal according to the entrepreneur’s needs without losing the deal.

What Happens After Being Approved?

For most of the funding rounds (excluding crowdfunding), both parties’ post-selection procedure is:

a. Signing a Non-Disclosure Agreement (NDA)
b. Drafting stock-purchase and voting agreements
c. Due diligence by the investor
d. Drafting the subscription or loan agreement
e. Deciding the investment terms
f. Formulating the term sheet on mutually decided terms.

These can vary slightly according to the type of investor.

Final Remarks - Basics of Seed Funding In India

There is a wide range of options and schemes to help entrepreneurs get seed funding. However, it is imperative to critically analyse the terms of payment, returns, dilution, and powers vested with the investors. Further, the investor’s sector expertise, financing capacity, and portfolio diversification shall also be considered while making a choice. Given the conducive environment for start-ups across the globe, a company shall witness considerable growth if the core team considers all the business and legal requirements.

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