Is All Investment Capital the Same Shade of Green?

Pros & Cons of Raising Capital from
In-State Vs. Out-of-State Investors

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Executive Summary

Context

The decision to raise institution capital is not one that should be taken lightly. Entrepreneurs must decide:

- how much capital to raise,
- at what price to raise that capital, and
- which investors to raise it from.

Purpose

This report focuses on the third variable listed above by examining the pros and cons of raising capital from local investors versus Out-of-State equity providers.

Data Source

For this report, we went to the Advanced Technology Development Center[1] ("ATDC") at Georgia Tech to study the companies in its incubator that received capital from equity investors between 2014-2019.

Methodology

Funded companies were grouped into two categories ("In-State" and "Out-of-State") based on where their investors reside. "In-State" represents companies that included investors that reside in the state of Georgia, and "Out-of-State" represents companies that raised capital entirely from investors based outside of Georgia.

Analysis

We examined the pros and cons of taking capital from In-State and Out-of-State lead investors across eight factors:

1. Initial check size
2. Initial valuation
3. Dilution (resulting from 1 and 2)
4. Impact on operating pace
5. Impact on follow-on capital raises
6. Impact on business outcomes

7. Impact on long-term value creation
8. Impact on expected equity value (incorporating 3, 6, and 7)

Conclusions

Our study finds little evidence that taking on Out-of-State investors drives more attractive valuations and better business outcomes for founders, despite a common belief that it does. In fact, the data suggests that exactly the opposite is true. When we compared the outcomes of the two cohorts, we learned that founders who accepted local capital:

1. Received initial check sizes that were approximately half the size
2. Received initial valuations that were approximately half the valuation
3. With (1) and (2) in concert, experienced **less initial dilution**
4. Executed at a slower pace of cash burn
5. Raised successive rounds of capital more often
6. Achieved exits more frequently and went out of business less frequently
7. Reached similar enterprise values over time
8. Saw significantly greater expected equity value

In short, from the data studied we conclude that:

1. The benefits to founders of taking In-State capital are clear and should be considered by anyone embarking on a capital raise.

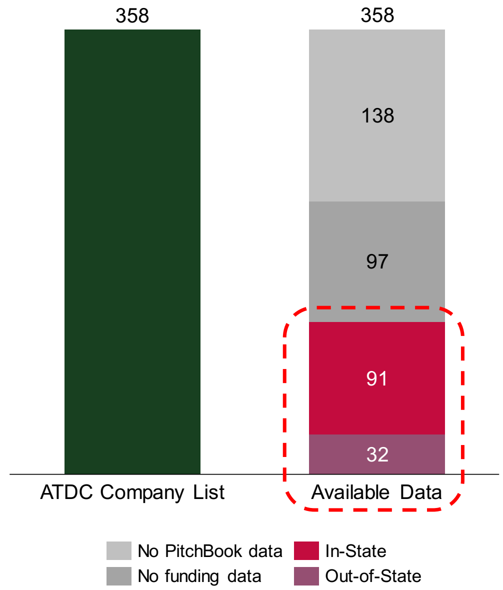
2. Founders who take Out-of-State capital give up more of their companies and assume meaningfully greater risk of business failure for no upside (on average).

Please see the full report below for more detail.

[1] *As the preeminent technology incubator in the Southeast, ATDC has been helping founders build great businesses since 1980. We worked with leadership at the ATDC to establish the dataset of companies examined in this report, which is their list of participating companies from 2014-2019.*

The Dataset

Our initial dataset of 358 companies included all ATDC participants dating from 2014 to 2019. Starting with these companies, we used PitchBook to gather firmographic and financing data. For many of the companies, there was insufficient or no available data, leaving us with a final dataset of 123 companies. Of these remaining 123 companies, 91 have pursued "In-State" capital partners while 32 have pursued an "Out-of-State" strategy.



We recognize that there are limitations to this report based on the data examined, including but not limited to: Completed financings not captured by PitchBook and the time bias inherent when looking at follow-on capital in any current dataset. Both additional financings not captured and future follow-on capital rounds will impact the results of this study.

Impact on Early Financing Dynamics

Entrepreneurs are often drawn to the allure of larger checks and elevated early-round valuations. And the data tells us that, consistent with common belief, if a founder simply wants a large check and a high valuation, an Out-of-State strategy might be the right route.

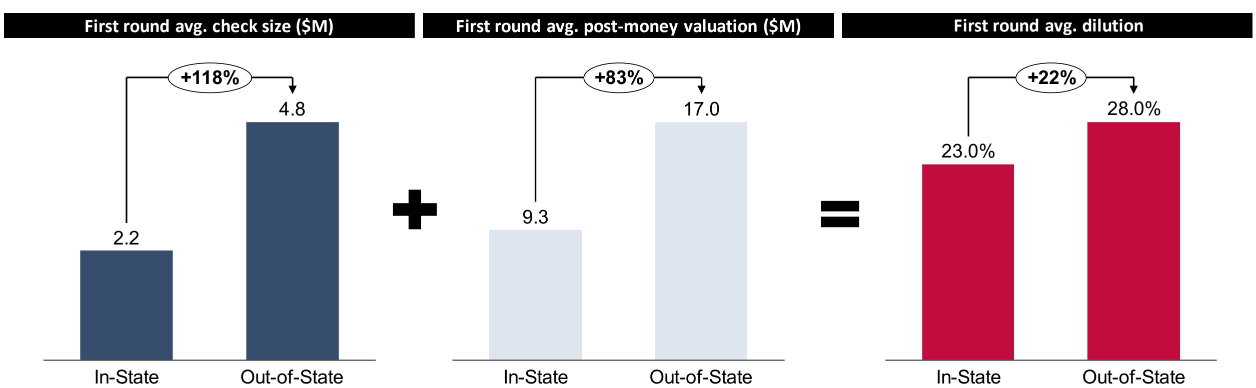
Check Size:
Across our dataset, the check size for a company's first round of financing was on average $2.2M for In-State capital companies and $4.8M for Out-of-State capital companies—a 118% larger check, on average, from Out-of-State capital investors.

Early Valuation:
Like check size, Out-of-State capital carries higher valuations at early stages. For In-State capital companies, the average post-money valuation for first-round financing was $9.3M. For their Out-of-State capital counterparts, the average first-round financing post-money valuation was $17.0M—an 83% higher valuation from Out-of-State capital.

So, if one investor offers both a larger check and higher valuation than another, it must be better, right? Not necessarily…

Dilution:
Next, we looked to understand dilution dynamics. For this we took average check size for each investor classification and divided by average post-money valuation for first-round checks. While this "average of averages" methodology is not perfect, it is directionally correct.

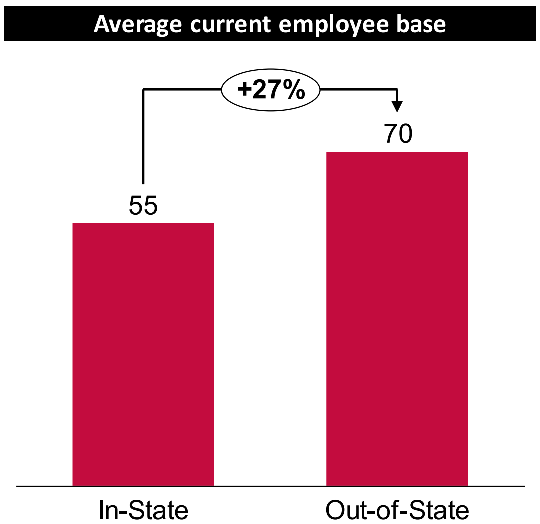
Because average check size was 118% larger, but average valuation was only 83% higher, first-round dilution for companies taking money from Out-of-State capital is higher. On average, founders own 5% less (72% vs. 77%) of their companies after taking capital from Out-of-State investors in early rounds, a dilution increase of 22%. Said differently, when accepting money from Out-of-State investors, each $1.00 raised is 22 cents more expensive.



Capital from Out-of-State being meaningfully more costly begs the question: **"What do founders get out of raising larger sums of more expensive capital?"**

Impact on Operating Dynamics

Understanding the impact of the choice of capital partner on operating decisions and value creation is critical to understanding an investor's value-add. There are numerous ways to attempt to quantify that value, many of which are not possible given the private nature of the data required. For this report, we sourced the latest available employee count data from PitchBook.



On average, the latest headcount of companies in our dataset for In-State capital companies stood at 55, while the latest headcount for Out-of-State companies stood at 70—a full 27% higher. While not a perfect indicator, it does give us a glimpse into the relative cash burn mentalities surrounding our two investor classifications. It seems Out-of-State capital and the larger rounds support operating plans that load companies of similar performance with 27% higher payroll responsibilities.

The next question to answer is: "When a company takes on a larger round of capital at an elevated valuation, then ramps up expense, what does that mean for its ability to raise subsequent rounds of capital?"

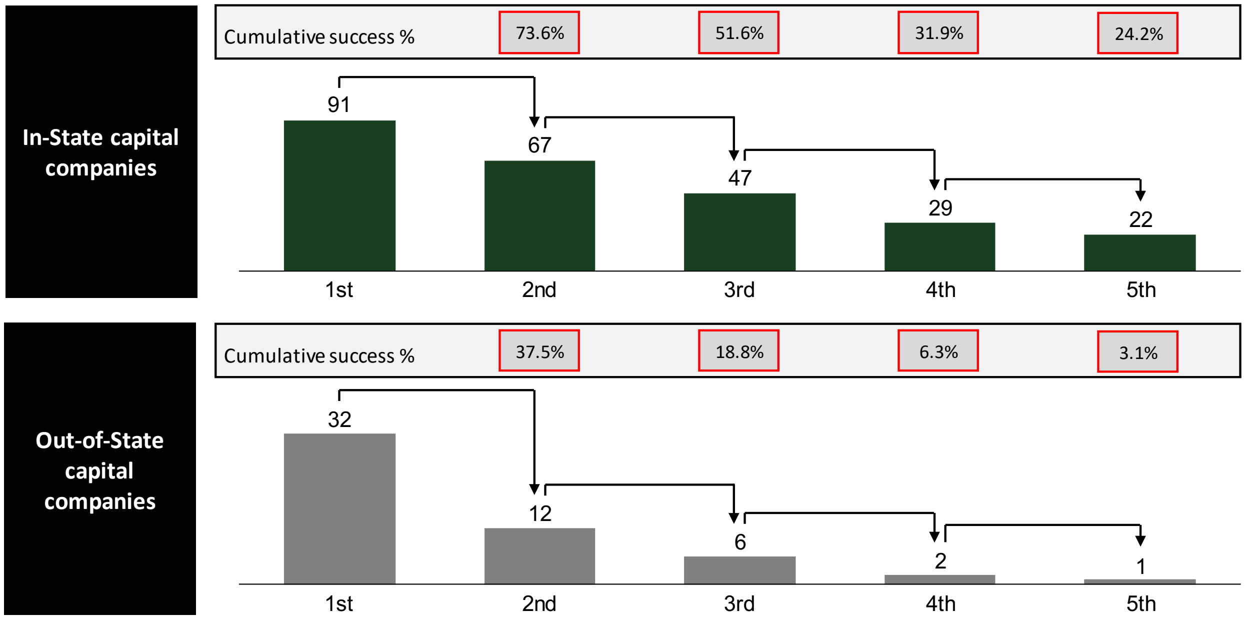
Impact on Sequential Fundraises

We looked to answer the question above regarding subsequent capital raise success.

Our dataset included funding rounds numbered "1" through "10." However, for the purpose of this analysis, we included only rounds "1" through "5" (PitchBook classifications), with our rationale being that later rounds of capital typically come from more buyout-oriented funds, and these funding rounds are not the focus of this study. The difference in sequential fundraising success when comparing In-State and Out-of-State capital companies is detailed below.

Out-of-State capital businesses in our study raised a second round of capital 37.5% of the time. In-State capital companies raised a second round of capital at a rate of 73.6%, or 96% percent more often. This trend holds through the third, fourth, and fifth rounds of capital. Out-of-State capital companies reach a fifth round of funding a mere 3.1% of the time. In-State capital companies successfully reach a fifth round of funding 24.2% of the time, **approximately 770% more often.**

The below chart displays the full waterfall of successful raise data.



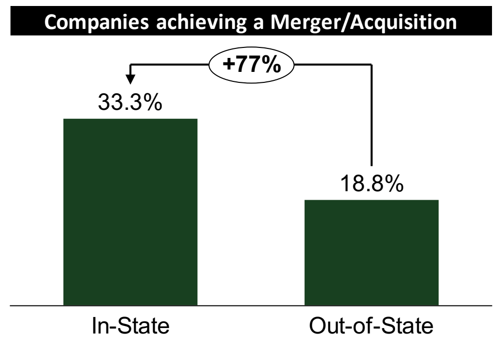
This supports our theory that early operational support as a business scales allows the business to reach milestones that warrant additional investment. Out-of-State capital typically takes a more "scattershot" approach with its initial allocation and is not close to the progress the business has made outside of your standard metrics, dictating that it won't follow on if a business struggles to scale early on. Alternatively, In-State capital investors seem to take a more measured approach, investing smaller rounds of capital, staying close to their investments, and following on as they make progress.

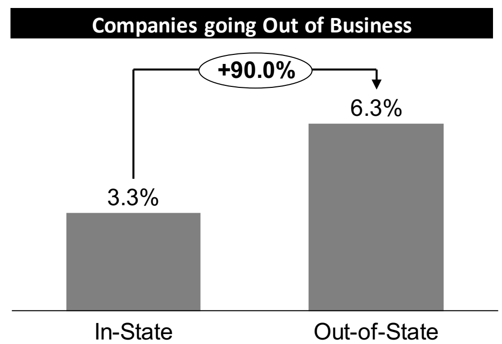
Impact on Business Outcomes

Next, we looked at the impact that investor classification had on business outcomes. We defined business outcomes as:

1. Mergers
2. Acquisitions
3. Out of business (or bankruptcy)

Presumably, given that companies across investor classifications received meaningfully different initial funding terms, accelerated their businesses along deviating trajectories, and raised capital to different degrees of success, we expected to find divergence around business outcomes. That was not the case.





For Out-of-State capital businesses, the rate of merger or acquisition across companies was 18.8%, compared to a rate of 33.3% for In-State capital businesses, meaning that founders taking capital exclusively from In-State investors have realized exits approximately **77% more often than their Out-of-State cohorts.**

But what about negative outcomes?

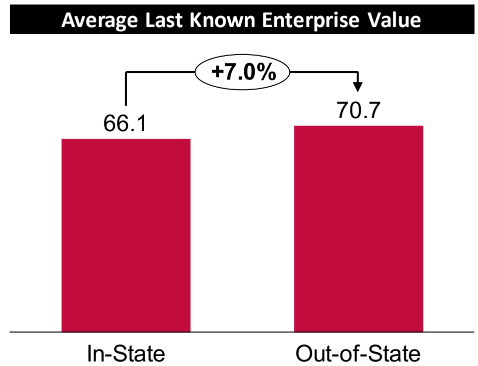
3.3% of In-State capital businesses in our dataset have gone out of business, while 6.3% of Out-of-State capital companies have gone out of business—a 90.0% higher rate of failure for Out-of-State.

While this sampling is likely affected by the short operating histories of some companies in our dataset, the story appears consistent with the other findings herein. As companies raise large rounds at lofty early valuations, it becomes increasingly more difficult to raise subsequent rounds of funding. In the startup world, capital and its judicious deployment are valuable assets. Without pairing them properly, businesses can quickly change course from a deliberate walk toward success to an all-out sprint toward the business graveyard.

Impact on Long-Term Value Creation

Finally, we looked to understand what value entrepreneurs across the two investor classification groups realize assuming they *do* successfully run the gauntlet. How does the choice of capital provider impact the prospects of long-term valuation?

To answer this question, we looked to PitchBook's "Last Known Valuation" data field. Looking only at companies that have shown up on PitchBook's radar with a notable valuation (and excluding the bankruptcies), we expected Out-of-State capital companies to have meaningfully higher valuations. It stands to reason that, given more aggressive operating plans, the companies that did not go out of business due to accelerated cash burn would build higher enterprise value over time. Our findings were directionally in line with that supposition, but not nearly to the degree of our hypothesis.



In-State capital companies, of which we had 67 "Last Known Valuation" data points, achieved an average enterprise value of $66.1M. Out-of-State capital companies, of which we had 26 data points, achieved an average enterprise value of $70.7M. This means that, if companies taking capital from Out-of-State investors are successful, they generate valuations that are on average a mere 7.0% higher than the In-State capital companies.

Putting all the Pieces Together

And now, the natural question arising from any study: "So what?" At BIP Capital, as both entrepreneurs and data-driven investors, we believe the more pointed question is: **"As a founder, what is my expected equity value for each path?"**

To do this, we will compare the answers to the following two questions from the perspective of a founder:

1. Given In-State capital, what is my expected equity value (percentage chance of a successful outcome **times** average enterprise value **times** retained ownership)?
2. Given Out-of-State capital, what is my expected equity value (percentage chance of a successful outcome **times** average enterprise value **times** retained ownership)?

This is an oversimplification of the inner workings of capitalization tables, debt requirements, and other obligations at the time of a liquidity event. But, like any financial model, the illustration is merely a tool to inform decision-making.

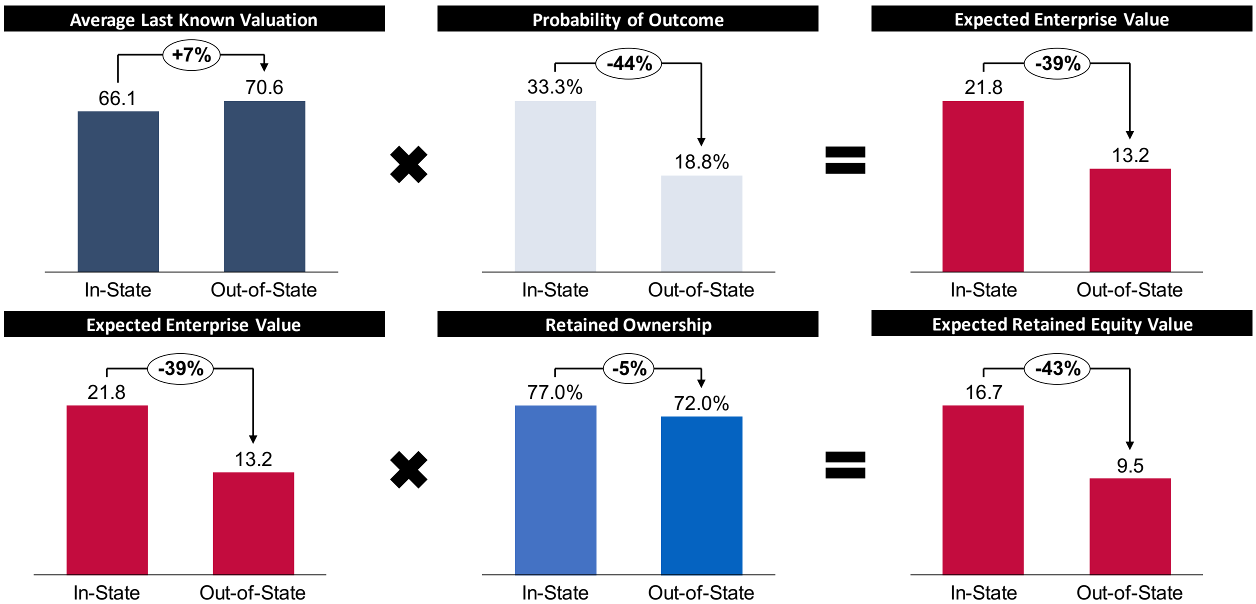
For illustrative purposes, we start with two theoretically identical companies. The In-State capital founders can expect to retain 77% of their business, while the Out-of-State capital founders can expect to retain 72% ownership of their business. Hold on to this; we'll come back to it…

We begin our expected value calculations with the average enterprise value given a successful outcome for each investor classification. Recall that these values for In-State capital and Out-of-State capital were $66.1M and $70.7M, respectively. To arrive at expected value, we take each of these values and multiply by the probability of a successful outcome. Again, recall these values for In-State capital and Out-of-State capital were 33.3% and 18.8%, respectively. Given success, we arrive at expected enterprise values of $21.8M for In-State capital companies and $13.2M for Out-of-State capital companies.

Now we will factor dilution into our equation. While In-State capital founders retained 77% of their companies, Out-of-State capital founders retained only 72%. Applying this last piece gives us an expected equity value to owners of $16.7M for In-State capital founders and $9.5M for Out-of-State capital founders.

In short, for the ATDC participants in our study, In-State capital founders had an expected equity value that was $7.2M higher (75%) than Out-of-State founders.

The graphic below illustrates the above calculations.



Interpreting the Results

The various impacts of investor classification on each dependent variable tell a very cohesive story, even with a complex dataset. Simply put, it appears that founders who exercise an Out-of-State capital strategy give up more of their companies and assume meaningfully greater risk of business failure for no upside.

To this end, we conclude that Out-of-State money isn't necessarily "greener" and in aggregate looks to be the less-optimal choice for entrepreneurs. It's not because Out-of-State capital providers are bad investors. In fact, most of the ones in our dataset are quite successful. But from a founder perspective, we strongly believe the reason for this stark difference is rooted in the involvement and support provided to businesses after investment to help them scale. Therefore, entrepreneurs should look to partner with a capital provider that can help them with the intangibles of building a business, not just those that will give them a high valuation. As the data shows, this is a surer path to success.

Building and sustainably growing a business is an immensely difficult task. We hope that this analysis sheds some light on the relatively opaque process of raising capital.

We Invite You to Apply Your Insight to Our Dataset

Our takeaway from our research is that Georgia-based startup founders are, on average, better off taking capital from In-State capital providers. While some startups may be able to secure a larger round at a higher valuation from Out-of-State capital providers, the unintended impact of that choice may put them on the fast track to failure.

We suspect our conclusions will be surprising to some, especially to advisors who operate with anecdotal (as opposed to data-driven) commentary about the best sources of capital for startups.

We also suspect that many people will conclude that our research is biased and self-interested. However, over the last five years – even though we have been the most active investor in Georgia – over 50% of our new logo investments are based outside of Georgia.

Our goal in conducting this research was simply to see if Out-of-State capital was truly "greener". Based on the data we analyzed and the methodology we used, it is not.

We welcome additional analysis on the dataset we analyzed as our goal is to help founders optimize outcomes (optimal financing round, size of exit event, personal value creation, etc.). Please reach out to smoore@bipcapital.com if you would like access to the dataset.

Additional Considerations

In publishing this research, we recognize that we need to be careful drawing definitive conclusions. First, our dataset is limited to ATDC companies over a relatively short period of time (five years). It is entirely possible that our dataset – which is Atlanta-centric – is not representative of other geographies or that this short window of time is not reflective of the truth over longer periods of time.

Second, we are not seeing any discernable difference in performance by our Out-of-State portfolio companies vs. our In-State portfolio companies. This either suggests that our Acceleration Platform mitigates the challenges caused by large distances between startups and capital providers (BIP Capital in this case), or it suggests that the outcomes of the ATDC dataset are an anomaly.

Future Research

Our experience in helping startups scale and avoid critical mistakes, coupled with watching startups funded by other venture capitalists, teaches us that **value-add beyond money** (intangibles) is the critical variable in mitigating the risk of failure and in creating more predictable outcomes for founders. This topic will be the focus of future empirical research by our team.

Acknowledgments

We want to extend a special thank you to the Advanced Technology Development Center for its collaboration on this report. We have partnered with ATDC for over 15 years, and with a shared vision, we look forward to working with them for many years to come. You can learn more about ATDC at www.atdc.org.

We would also like to thank PitchBook for the data required to make this study possible.

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