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Without access to capital most start-ups and scale-ups will not be able to fund development, their working capital needs and, ultimately, will be unlikely to reach their full potential. In order to successfully navigate the funding trail, founders need to be equipped with a working understanding of what a fundraising process will involve. This instalment in our Start to Scale Essentials series seeks to address many of the key considerations for entrepreneurs seeking investment.

Fail to prepare; prepare to fail

You need to build confidence with investors, who are buying into you as much as the underlying business. Investors will expect founders to be well prepared and to demonstrate the right mix of optimism and realism about the potential scale of their business opportunity.

Get your paperwork in order

The first step in any fundraising process is to get your paperwork in order, particularly your financials, business plan, projections, market research and pitch deck.

Have your pitch in order

Your pitch deck should be capable of being left behind with investors and provide the framework for any opportunity to pitch. Founders will, quite possibly, receive a number of rejections. Don't take it personally – there are a number of reasons why your opportunity may not have been the right fit for that particular investor. Rather, if the opportunity is sound, refine your offering and return with greater determination.

Scope the investment

You should thoroughly assess your investment proposal. What is it you are offering? How much of it is being offered? What will it cost? Are there any tax advantages in taking it? Founders should be able to answer all of these questions. Taking too little or too much investment can be dangerous, so understanding your funding requirement is key.

Arm yourself with an understanding of the likely terms (as well as some of the jargon)

An investment will ordinarily come with terms. These need to be understood and negotiated. Below are some of the key items that will ordinarily make up a term sheet.

- Valuation

Founders need to understand the dilution of the investment round. For example, if an investor places a 'pre-money' valuation (the value of the company before the investment) on the company of £4 million, the company has a share capital of one million ordinary shares and the company is offered an investment of £1 million in return for ordinary shares, the dilutive effect of the round is 20%. However, if the £4 million valuation was a 'post-money' valuation (the value of the company following the investment), the dilutive effect would be 25%. A big difference depending on whether the valuation is pre or post money. Other items, such as the treatment of any new share option pool, will also affect the level of dilution.

- Share class

The two most commonly encountered share classes are ordinary shares (often referred to as common shares) and preference shares. Preference shares will typically, on a return, entitle the shareholder to receive the amount they invested in priority to any return on the ordinary shares. It is also common that preference shares can be convertible into ordinary shares at the option of the shareholder (i.e. in circumstances where the return on ordinary shares would exceed that of the preference shares). The use of preference shares provides investors with some 'downside protection' to ensure they receive their money back (or a proportion of it) ahead of a return to the founders (who typically hold ordinary shares). In some cases, preference shares can entitle the investor to both their money back before all others and then a proportional share in the remaining proceeds of any exit – that sort of preference share is known as a participating preference share.

- Information rights

Investors will request certain information rights from the company, such as monthly management accounts, annual accounts and business plans within agreed timeframes. This information will often be required by an investor (particularly by investment funds) to meet their own reporting requirements. You need to have the structure and processes in place to meet any such requirements before entering into an agreement with an investor. Often these obligations will be outsourced to a company's accountants.

- Appointment rights

Some investors will seek board appointment rights as part of their investment. This means a representative of the investor will join the company's board at closing, or the investor will be able to insist on such an appointment at any time post-closing. It is important to ensure such appointment rights do not create an unwieldy board structure, which restricts the agility of the company.

- Reserved matters

Because investors wish to ensure that value is not lost from the company in which they have invested, they will customarily insist on a set of reserved matters. These seek to protect the value of the business and ensure that, without the consent of a qualified majority of the shareholders (or investors), the company cannot undertake those reserved matters. Typical items include discontinuation of the business or a related party contract.

- Pre-emption rights

Pre-emption rights give investors (and often shareholders generally) the right to maintain their proportionate ownership of the company through subscribing for their respective proportion of new shares to be issued in subsequent funding rounds. If, following the completion of the pre-emption process, shares remain unallocated/unsubscribed for, the company will usually be free, within an agreed period, to issue unallocated shares to third parties at the price offered under the pre-emption provisions.

- Anti-dilution

Anti-dilution provisions seek to protect investors from subsequent down rounds (rounds in which shares are issued at a lower round price than the price paid by the investors) either by issuing additional shares to the investor or, if the investor holds preference shares, often by increasing the number of ordinary shares the preference shares can convert into.

- Right of first refusal

A right of first refusal grants investors (and often shareholders generally) the right to acquire shares being sold by other shareholders before these are sold to third parties. Shareholders must notify their intention to sell their shares and set a price at which the investors (or other shareholders) may acquire these. Typically, if the investors (or other shareholders) do not opt to acquire the shares, the selling shareholder will have a period within which to sell their shares at a price no less than that which was offered to the investors (or other shareholders) and on no more favourable terms.

- Drag rights

As the number of shareholders of a company increases so too does the risk of being unable to get unanimous agreement to the terms offered by a third party to buy the company and to have a voluntary sale. Founders and investors alike don't want to find themselves trapped with shares and no ability to exit. Drag rights permit a qualified majority of the shareholders of a company (often referred to as the 'dragging shareholders') to force the other shareholders (often referred to as the 'called shareholders') to sell their shareholdings on the terms accepted by the qualified majority. Drag rights seek to ensure an exit can always be achieved with less than unanimous agreement of all shareholders.

- Tag rights

Such rights ensure shareholders can exit on the same terms as the majority. These rights create liquidity for shareholders in circumstances where there is set to be a significant change in ownership (usually where a 'controlling interest' is being obtained).

- Vesting

Share vesting is the process by which founders receive the full rights to their shares or share options over a period of time. A key risk for investors is that the value of their investment will be reduced if a founder leaves. To combat this, investors often ask for the shares of founders to vest over a period of time after the investment has closed.

- Leaver provisions

Leaver provisions ensure that employees, and usually founders, who are no longer engaged in the business, can be forced to sell their shares. The price to be paid for such shares will depend on whether the leaver is a 'good leaver' (for example, incapacity) or a 'bad leaver' (such as when dismissed for cause). Leaver provisions ensure shares are not held by passive holders and (as discussed in our article on founders' agreements) can be recycled to other employees who are engaged to ensure that they benefit from future growth.

- Warranties

As part of an investment round the company and, frequently, the founders (the warrantors) will be asked to confirm certain statements of fact, referred to as warranties. These are the assumptions on which the investor based their valuation of the company (e.g. that the company is not subject to litigation). If the warrantors do not disclose any circumstances in which the warranties are untrue, the investor may raise a claim for breach of warranty and readjust the value post-closing through a claim for damages.

- Exclusivity

Investors do not want to invest time and expense in an opportunity only for the company to 'shop' their term sheet and use it to improve terms with another investor. Accordingly, investors will often provide a short window within which the term sheet is "open" for acceptance and also look to agree an exclusivity period (often 30 to 60 days after the term sheet has been signed) within which the company is unable to undertake, or solicit, another investment opportunity. Founders need to ensure they have enough runway to survive such an exclusivity period and are not exposed if a funding does not close during it.

Identify the right investors

With an understanding of the investment terms, and your preparation well advanced, the last step is to identify the right investors for you. Always view investors like partners. They need to be the right fit for you and your company. Founders should not prioritise valuation at the cost of fit, ethos, familiarity and the added value that a potential investor may bring. In fact, an overvaluation can be problematic as founders may find it hard to show sufficient progress in future to support an increased (or even a stable) valuation at a subsequent funding round.

Shepherd and Wedderburn's corporate team combines industry knowledge and extensive experience with technical expertise, and is on hand to assist businesses at all stages of their growth journey. The team's Start to Scale initiative, comprising written guides, video content and in-person events, addresses some of the specific challenges affecting start-ups and scale-ups throughout their lifecycle to give entrepreneurs the insight they need to scale.

Visit shepwedd.com/start-to-scale for more information, or contact [John Morrison](#), Partner in Shepherd and Wedderburn's corporate team, at john.morrison@shepwedd.com.

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