



Ali Al-Suhail, CFA

The Investment Landscape: Other Variables of the Investment Equation

The Iraqi Ecosystem is alive and well. I write this as a new article coming out by Wamda is titled "Iraq's Big New Opportunity". The article reiterates the messages from the Iraqi Digital Transformation Summit; Iraq's population is young, internet-savvy, and has a relatively strong spending power, which presents a very attractive consumer market. Also, there are groups of brave entrepreneurs rising to address the market's needs and problems. However, the ecosystem remains to have serious challenges, which can be attributed to the outdated regulatory regime, weak banking system, and a neglected education system.

On the investment front, we have seen continued investments into Iraqi startups. Zajil/Alsree3 raised a seven-figure mezzanine round and Orisidi raised a follow-on round. Both companies received their investments from syndicates of investors. The mezzanine round of Zajil/Alsree3 included its previous investors coming back to invest additional capital and a new set of investors as well.

This is becoming a common trend in Iraq, where investors are doubling down on their investment into Iraqi businesses highlighting the potential of the market. On top of this, we are seeing increasing interest from regional players looking to enter the Iraqi market.

Furthermore, the early stage investment in Iraq is mostly focused on e-commerce and its enablers. E-commerce usually serves as the area where capital first flows in the ecosystems. The product/market fit is obvious and the success metrics are well established.

This is different when it comes to Software as a Service (SaaS) businesses or platform startups. As such startups require capital and time to prove product/market fit and to develop their core product. This does not only make it difficult to assess the premise of the business but also challenging to determine whether it is heading in the right direction or not.

To put things into context, here is a quote from the founder of SuperHuman, an email agent company: "We had set up a shop and started coding Superhuman in 2015. A year later, our team had grown to seven people and we were still furiously coding. By the summer of 2017, we had reached 14 people — and we were still coding. I felt intense pressure, from the team and also from within myself, to launch. My previous startup, Rapportive, had launched, scaled, and been acquired by LinkedIn in less time. Yet here we were, two years in, and we had not passed go."

Superhuman valuation today is \$260 million and is increasingly recognized as one of the best email agents in the world. For investors in Iraqi startups, this presents an additional challenge, the uncertainty of early stage investing is made more difficult by a volatile market.

Most investors look at the valuation to price such risks. While this approach caters well to more mature companies, it fails to address the dynamics of startups.

Startups or small and growing businesses are all about growth. Growth is never cheap and it usually comes with the price tag of a highly committed team and a good supply of capital. This makes the valuation a balancing act for both founders and entrepreneurs.

Founders that overshoot the valuation of their business will struggle to attract capital at further stages to match investors' expectations. Investors risk making entrepreneurs lose their commitment by turning them into employees with dilute shareholdings. Globally and regionally, this has caused many innovative tools to emerge to structure investments into startups; especially at the seed stage where valuation is the hardest to assess.

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It should be noted as well that while valuation is a key factor in the investment, it is accompanied by other contributing factors that make up the investment offer (i.e., the term sheet). The terms sheet usually includes many items that de-risk the investment from the investor's perspective and provide guarantees against the performance of the company.

The most common company registration structure in Iraq is LLC. While this structure is cheaper and faster to process, it has a major drawback as it does not allow the company to issue multiple classes of shares. This, in turn, does not authorize different rights to each class of shares and as a result, makes it difficult to incorporate terms that are now popular in startup investing such as liquidation preference and anti-dilution.

In terms of valuation, I would like to bring attention to few methods that investors can utilize to protect their investments:

Milestone-based drawdowns:

Investment into startups can be structured wherein money flows in the form of tranches into startups. Each tranche is drawn once the startup achieves a certain milestone; either based on hitting a certain operational milestone (launch of an application) or a commercial milestone (acquiring a certain number of customers or users).

A mix of different investment instruments:

While investments into startups are traditionally made in equity on the basis of the business ability to repay creditors in the case of debt. That being said, companies with SaaS business models typically have good margins and can handle some debt. Investment can be made in the form of equity against a stake and a debt with a certain grace period. Another structure that can replace debt is revenue-based finance.

Use of self-liquidating equity:

Investors can also consider buying a larger share of the business and provide the company with the ability to buy back the investors' shares based on the business paying back the investors.

The legal form can be challenging and will need strong legal expertise to apply this within the Iraqi context. Nevertheless, such instruments should be considered by investors as methods to decrease the risk of their investments. In the context of startup investing, such structures are vital for a healthy ecosystem and continued investment. Therefore, we need the legal community to start finding legal forms to implement such structures.

The fundraising landscape in Iraq continues to develop at a rapid pace and more investable startups are emerging. The latest cohorts of our own ScaleUp Academy and Takween are presenting many more investable businesses. Smart capital will be essential for those businesses to reach their potential.