PITCHIT FINTECH STARTUPS PODCAST NO. 39-DON MUIR

Welcome to PitchIt, the fintech startups podcast, one founder, one startup, one investor at a time. I'm your host, Todd Anderson, Chief Product Officer, LendIt Fintech.

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Todd Anderson: On Episode 39, I talk with Don Muir of Arc. Arc is the full-service financial platform for Software-as-a-Service startups, they provide software startups with a customizable financial platform that they deserve. The process of raising money is quite arduous, there's a lot of time and energy that founders need to set in order to raise capital, whether it be from VCs or private equity firms or from banks and other traditional lenders.

Arc is aiming to solve part of this equation with a state-of-the-art financial platform, they help companies unlock future revenue without taking on any risky debt or further diluting their equity stakes. Don and I talk about some of the biggest pain points for founders when they fundraise, how Arc's solutions can be additive to VCs and other lenders, Arc's partnership with Stripe, how his experience as an investor and private equity is helping to shape how he builds Arc, raising capital and a whole lot more. So, without further ado, I present Don Muir of Arc.

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Welcome to the podcast, Don, how are you?

Don Muir: Hey, Todd, I'm doing great. Thanks for having me.

Todd: Of course. So, you know, I'd like to start these episodes, if you can just tell the audience a little bit about yourself, where has your professional journey taken you before Arc and how did you come to the idea of Arc?

Don: So, I'm originally from New York, right I think where you're sitting now. I worked in consulting, a company called BCG and then in private equity at a fund called Onex Partners to large publicly traded private equity funds. From a very young age, I've been passionate about finance and investing and I ended up working for a value-oriented private equity fund in New York where we got to invest in large, multibillion-dollar financial transactions. After a couple of years, as the learning curve started to plateau, I realized that I wanted to do something different and I picked up and moved across the country to enroll at Stanford Business School where I met Nick and Raven, the two Co-Founders at Arc.

Nick, like myself, he works in private equity investment banking in New York, he worked at a competing fund. As it turns out, we actually worked in a bunch of the same transactions prior to business school without knowing it so we moved across the hall from each other at Stanford GSB, we had a lot in common, immediately became friends, but what was interesting is that what unified us more than the actual finance background was our interest in entrepreneurship. Raven was one of the other 400 folks in our class, he was a Facebook and TESLA software engineer who is also passionate about finance and the three of us put our heads together and founded Arc, raised our seed round out of the GSB, have been building the business ever since.

Todd: So, you mentioned the entrepreneurship angle there with one of your Co-Founders, now have you always wanted to start your own company from long ago and you thought alright, I'll do maybe investment banking or do investing and eventually get there or did it happen to be that you went to business school, you met your Co-Founders and kind of the idea came out and you kind of fell into being an entrepreneur?

Don: Entrepreneurship has always been an interest of mine and I always had a hard time fitting out with my passion for finance and investing. The private equity hedge fund/investing banking path was always appealing to me because I appreciate the role of finance and the fundamentals of business as in analyzing companies' financials. But, when I came to Stanford and started to meet dozens and eventually hundreds of founders in and around the Bay Area, I became inspired and I realized that I could couple my passion for finance with my interest in entrepreneurship and technology by starting a fintech platform designed to effectively invest in and/or analyze the fundamentals of businesses to provide value.

Todd: Before we jump into exactly what you guys offer with Arc, how'd you come to the name of Arc?

Don: Definitionally, an arc is a curved path and mathematically, it pertains to a portion of a circumference of a circle. When you think about the actual S-curve or a growth pattern of an early-stage company, the very vertical portion of the curve can be the most chaotic, it can also be the most capital-intensive aspect of starting a new business or a new venture. With Arc, we wanted to part of that upward trajectory, a part of that journey, we want to help companies grow efficiently, grow quickly while preserving ownership in their business and that's the really the mission of Arc.

Todd: I was always curious to ask that question because, you know, sometimes it seems obvious, at other times I've heard from founders who say they basically took a Latin dictionary and opened it up and flipped through pages and came to their name that way. So, it's always fascinating to hear how company names come together. Tell the listeners exactly what you guys do at Arc and ultimately, who are your target customers.

Don: What we're building in the nth state, we want to be the full-service finance solution for SaaS founders. What we're starting today is with a non-dilutive capital product where we can go in and we can divert future revenue into upfront capital for software startups. So, what does that actually mean?

We work with seed through Series B startups, we'll run their backend financial data through our automated underwriting engine and we'll product finding terms. What their terms say is you have $1 Million of financiable revenue, we can convert that into $950,000 today without transaction fees, without warrant coverage at the click of a button, we make that capital available for you today to invest in your business, accelerate your growth without dilution and unlock your next milestone ahead of your next equity rates.

Todd: When doing some research for this episode, you know, reading the stuff that you guys have on your website as well as some articles that have featured you guys, you mentioned a lot of the pain points for early-stage SaaS companies raising capital. What are kind of the core issues that these companies have when it comes to fundraising, especially if you can mention, you know, I saw I think it was either in an article on your website where you talk about slow offline and transactional process.

Don: I would bifurcate between the disruptive nature of the actual financial solution we're offering with the technology and how they come together to produce our product and what it is today and when you think about traditional capital raising processes, they are offline, analog, destructing processes for management teams. They've got to meet dozens of investors, equity investors who may or may not invest in their business. Typically, those investment decisions are agnostic of the fundamentals of the business, particularly in the earliest stages. When you think about debt, which is a form of non-dilutive capital, banks typically don't serve the early-stage segment of the market, seed, Series A, the check sizes are too small to move the needle for a large bank, the marginal cost is too high.

We use technology to overcome that hurdle so in terms of the actual financial product, equity is dilutive and debt is burdensome to the balance sheet, it's risky. There's an actual risk of insolvency by taking on debt on your balance sheet. Our product is different from off-equity and debt because we don't take an ownership stake so it's non-dilutive and we're not structured as traditional debt, there's no risk of insolvency using our product.

So, in that sense, we're a premium product to both equity and debt, we sit somewhere in the middle as an alternative. In terms of the technology I was alluding to earlier, we use technology to access early-stage companies at scale so a traditional bank will have a high marginal cost to cut a $500K to a million dollar check, we can do that algorithmically through our programmatic underwriting process which is fully self-serve, customers can come in, integrate their financial stack, make a real-time underwriting decision, we can advance some cap within two business days.

Todd: So, with the technology product that you guys have, say I'm a business owner, how much time will it take me to kind of set this up so that automated underwriting decision takes place? Am I uploading documents, am I giving you guys access to whatever accounting system I have, how does that piece work when you're talking with investors or banks, you know, there's a lot of leg time in it, there's endless amounts of alright, here's this piece of paper, I'll send it to you via email or do I have to gather these stack of papers?

You know, how much quicker is it for a founder to go ahead and use your technology and then theoretically, if I'm hearing you correctly, they wouldn't have to be constantly sending pieces of paper back and forth, it seems like it's a one and done process and then it's kind of automated from thereon?

Don: Definitely, and that is one of the biggest learnings I had moving from New York to San Francisco. What I saw in the private equity days is in order to underwrite a large financial transaction, it takes teams of investment bankers and underwriters. You have a very manual offline process, their data room is set up, they're sending Excel files back and forth (laughs), it's just a very long and inefficient and very expensive process. Moving to Palo Alto and meeting with hundreds of software founders, one of the biggest learnings I had was the increasing accessibility of financial data, backend API integrations unlock continuous in real-time access to the same financial data that would take us weeks to months to process in a private equity setting for a leverage buyout transaction.

So, what we're effectively doing is playing on the strength, we're getting real-time access to our customers' banking billing accounting data through backend API integrations, we feed that data through our underwriting model. Assuming that they have the right systems in place, we can make underwriting decisions effectively instantaneously to the extent that the system…they're on a bank that doesn't integrate with Plaid, for example, who we use for our banking integration, it can be a more manual process either way, the longer it's taking for us to turn around funding terms is five business days.

Todd: Going back to the example of $1 Million in future revenue and you can unlock or hand you $950,000, how does Arc make money? You mentioned a no transactional fee on the capital, do you guys charge a subscription fee, do you charge a fee depending on how much of the future revenue you unlock, what's the Arc model of making money?

Don: So, every company that onboards with Arc which, by the way, takes an average two minutes, we ascribe an Arc Score, that's our dynamically priced risk of doing business with this company. So, depending on a variety of metrics, again, this is fundamentally driven, so MRR growth, net revenue retention, LTD to cap, we're running all of these metrics, about 200 of them in total, against industry benchmarks and other customers in our portfolio and that produces what we're calling an Arc Score.

It's numeric value, zero to 100 that's inversely correlated to the risk profile of your company, it also pertains to the take rate we charge our customers. So, if you are Todd SaaS Co. and you have best-in-class fundamentals, you have an 83% gross margin, you're growing 7% month-over month, your net revenue retention is 110% then you'll produce something in the low to mid-90s, that would imply, let's say, a 5% take rate if you have a 95 Arc Score. We pull forward that million dollars of revenue, we're netting it of the 5%, we're giving you $950,000 today and we'll clip the $83,000 a month of revenue that we're effectively purchasing from you over the course of 12 months. That 5%, that's Arc's revenue and so we make money by comparing that 5% versus our own cost of capital from the credit facility we raised as part of our fundraising process.

Todd: That makes sense. I saw on your website that you guys have a partnership with Stripe, you also work with a lot of VCs and other traditional funders, can you talk a little bit more about that and just from the outside looking in, would this potentially be hurting the VC or the traditional funder business? I guess on the face of it, it might, but does it seem that way considering that you're working with a lot of these firms?

Don: We're very friendly with VCs and it's one of the largest sources of lead generation for Arc. When you think about the venture capital industry and the product that they provide, it's similar to ours, right, it's capital. They provide capital for companies to help them grow, what they also provide is mentorship and introductions to new hires and to customers.

That's something we might do over time and it's certainly on the horizon and we can talk a little bit about our product roadmap, but, for now, we're working with VCs and when you think about how VCs make money, they're investing a dollar today and they're taking out $10 in a handful of years. What we're doing is providing incremental liquidity to their portfolio companies without taking any ownership stake so we're not diluting existing shareholders, we're not diluting existing employees and we're not diluting founders, all we're providing is growth capital to help them accelerate growth, hit new milestones and achieve a higher IRR for existing investors such as VCs.

Todd: As I'm hearing your message today, it's not like you're going in there to replace VCs, it's more to work in tandem with them over time.

Don: Yeah. We're another tool in the tool kit for software founders and their venture capital investors to leverage or boost return and accelerate growth.

Todd: What about the partnership with Stripe, I saw that you guys have that on your website, can you tell us a little bit more about that.

Don: I spent most of my time talking to customers and prospective customers and understanding what their wants and needs are. What I've learned is that there's no full service platform built for the software founder to access capital and grow efficiently. There's no place where they can both manage, effectively borrow and spend capital in one place so we're working with Stripe without going into too much details and we announcing each product as we launch them over the coming months, but we're working with Stripe to build out our full service product suite purpose built for the software founder.

Todd: So, you've mentioned at the beginning that, you know, obviously you worked in finance here in New York, what are some of the lessons from that side of the table that you take into what you're currently building? Obviously, you've been through fundraising processes, you mentioned you and your Co-Founder, one of your Co-Founders probably worked on the same deal unbeknownst to each other at that time, but you found out after the fact, what types of lessons have you learned from that side of the table that you're implementing today that maybe a current investor or a current founder might find useful if they were to listen to this podcast?

Don: We provide unbiased, fundamentally-driven capital which is a pretty dramatic change from how the venture industry, venture lending in venture capital has worked historically here in Silicon Valley. What I've learned from my time working for value-oriented, late stage, buyout shops is what metrics to track and how we can actually dynamically price risk. What we're doing is we're analyzing metrics like ARR growth, like I said before, and net revenue retention and doing cohort analysis to understand the health of a business and when we can't work with a particular customer because their benchmarks fall below a certain threshold, we'll actually work with them to help improve those metrics.

Those same metrics will help them realize a better valuation, a better access to capital on the equity markets and the goal for next fundraise so we can actually work with founders to help them better understand what metrics are driving their business, what they can do to improve those metrics and when they should work with Arc versus traditional sources of capital. All those learnings really came from my past life working and investing in private equity and management sales here in New York.

Todd: Oh, you took the same question that came to mind which is, is there kind of a threshold on that Arc Score, alright, they fall below 70, we wouldn't necessarily fund them. I don't know if there's a hard number you want to say, but is there kind of a range like, alright, it's kind of here that they fall below that, would they fall into a category of alright, they'll need score improvement?

Don: Ninety percent of our portfolio today sits in the top fortile (?) of benchmarks across growth, gross margin and overall strength of the company pertaining to our Arc Score. As such, our Arc Scores are indexing north of 90 or around 90+, there is a threshold we will underwrite, we're not in the business of doing bridge loans, companies that are running out of cash or haven't necessarily found product market fit, it's probably not the right time for non-dilutive capital.

It's really a great opportunity to work with a seed investor that's going to take that asymmetric bet on the upside growth potential of the business. What we like to do is work with companies that have found product market fit that are approaching or in that upward trajectory on the S-curve and we can them help them grow efficiently and preserve ownership as they accelerate their growth and unlock the next chapter of their business.

Todd: So, what's one of the biggest lessons you've learned since starting the company or best piece of advice that you've received since starting the company?

Don: What I would say is that capital raising can be a really emotional decision, it occurs at the highest level of the organization, whether it's the founder or the CFO or the C-suite executive. What I'll say to founders out there, well, venture capital can be very enticing, especially when you're being approached and term sheets are being thrown at you and valuations are at an all-time high, as at least they were about a month ago.

There are other alternative sources of capital out there, there is certainly a time and place for venture and we work with VCs and we can help you figure out what the appropriate time it is to raise capital. If you found product market fit, if you are generating a material amount of revenue it might be a good time to consider other sources of non-dilutive capital.

So, one of the biggest learnings I've had is that there are other sources of capital beyond traditional equity. And then in terms of advice that I've received around building Arc and around building the business, early on during our own capital raise, met with all types of potential angel investors and advisors. During one conversation I've had with another Stanford GSB alum, David Vélez of Nubank, who met with the three of us, myself, Nick and Raven, and what he suggested to us was two business founders and one technical co-founder was ensure that there is no divide between the engineering and business teams.

And what I've realized over the last, you know, nine months is I've never received better advice and that's been one of the defining attributes of Arc. We have engineers sitting in the bullpen with finance and sales folks, we talk every day, we have finance learnings, underwriting teachings, engineers are explaining the code base to the sales reps and for us, creating a really unified culture between both engineering and business is what is going to ultimately separate us from the path and differentiate our culture in the market.

Todd: Before we shift a little bit in the conversation, you know, right now, obviously fintech has been one of the hottest segments in the market, especially private capital flooding into companies. Over time, obviously, that's going to cool, markets will change, they'll shift, do you see Arc as gaining value over time as maybe valuations come down and the amount of capital is not as abundant as it is today, how do you see that playing out over time as things maybe cool a little bit in fintech and the funding options aren't maybe as abundant as some founders might see them today?

Don: I think about it all the time, particularly in a rising interest rate environment where public equities are getting hammered in the market and technology companies and VC-backed IPOs are being disproportionately impacted in the private markets today and as we know, it's fundamental investors that's determined by terminal value and how it's impacted by weighted average cost of capital and a higher discount rate. So, what we're seeing in the public market with valuations coming down for software business, for all tech companies and particularly VC-backed IPOs are being impacted my multiple of 2 to 3X to grow their market, that's eventually going to, and has already, impacted the cross over funds in later stage exits which is them impacting the valuations of Series C, D and ultimately, Series A companies.

So, what we're starting to see is not only is the credit markets tightening up as interest rates rise, but we're also seeing the equity markets, venture capital markets, the private side starting to tighten up. So, what does that do to Arc? To us, it's a challenge. Equity is becoming more expensive, debt is becoming more expensive with rising interest rates and that creates a really strong use case for non-dilutive capital. So, we're seeing… early-stage startup is really a seed and Series A flocking to the Arc platform organically, (inaudible) is up 100% week-over-week at this point and that's really driven by some shocks to the market as interest rates start to creep up so we view this environment very favorably for our business and we're here to help founders access capital when traditional sources of capital start to tighten up.

Todd: I want to shift a little bit. Obviously, you guys launched in the last year or so, as a founder now how do you prioritize and how do you stay on top of the trends? When talking to founders there's a fair amount of struggle with, you know, how much time and energy it takes to run a company, personal time so how do you deal with some of that dynamic as you're building your company that's beginning to gain some serious traction?

Don: Arc is effectively my entire life these days as it is for my Co-Founders, I'd say it's for the better, not for the worse that individuals that I work with are my closest friends and I spend effectively 100% of my time with them. How I say up on the news is talking to other founders. The best part about my job is I spend eight hours a day talking to the founders, CEOs, VP-Finance, CFOs of early-stage growth companies, I understand their business, I have my ear to the ground and I understand how the market is trending at all times in the early-stage growth space and that to me has been the most rewarding part of this job and I wouldn't trade it in for anything.

Todd: How big is the team today, are you guys all in one location, tell us a little bit more about the team overall.

Don: We're about 15 FCEs today, we're doubling that number over the next couple of months here, we're actively recruiting, to those listening, who are looking to join our rocket ship, we'd love to have a conversation with you. We're located here in San Francisco, I'm actually sitting…if you can see the video, I'm sitting here at our office in SoMa on Folsom Street. I'd say about 70% of the team is fulltime in-person, we have a hybrid structure, it's very flexible, you need to be in this market and we want to accommodate the individual needs of future employees and current colleagues.

Todd: How much of a benefit was it that you and your Co-Founders became friends and, you know, the camaraderie that you built at Stanford? Some founders kind of find each other accidentally, seems like you guys found each other while at business school and the friendship built and built a company, how much of a benefit is that when you're dealing with people that you not only enjoy working with, but essentially your best friends?

Don: I literally moved then across the hall from Nick, he was the first person I met at the Stanford GSB on the first day of school and as it turns out, we had a lot in common and, as I mentioned in the beginning, we're bonded not only by our shared interest in finance, but also our shared passion for entrepreneurship and we worked on a number of startup ideas before ultimately landing on Arc.

And to make the story more interesting, Nick, myself, we were roommates along with five other individuals from our class and Raven was a 5-minute drive away so when everything shut down during COVID, we would spend all day, every day tinkering on Arc and it was really that environment, in the heart of Silicon Valley, in the middle of minutes from Sand Hill Road where the three of us were working in my living room in Menlo Park founding this company, raising capital, building the MVP, recruiting our founding engineers. It was really the perfect storm for an entrepreneurial environment.

Todd: Do you ultimately view yourselves as a technology company or as a financial company?

Don: So, we're offering a financial alternative to traditional sources of capital, but that opportunity is unlocked entirely through our technology platform. We have backend API integrations that unlock the ability to make real-time underwriting decisions which reduces our marginal cost, enables us to go to market at scale, cut smaller checks with more companies. It's the technology that unlocks this opportunity, it's that financial product that makes it very attractive to startups.

Todd: So, we have just a couple of minutes left here, I'd like to end a little bit lighter with some fun. Do you have a favorite book and the last book that you read?

Don: Favorite book of all time has to be "The Great Gatsby" by Fitzgerald. The last book I read and I'm currently reading is "Steve Jobs" by Walter Isaacson.

Todd: Do you have a favorite sport or sports teams that you root for?

Don: That's a tough question. I'll try to lose a lot of interest on (inaudible), I was a seasoned fan of the New England Patriots growing up. Ironically, I was at the game where Tom Brady got hurt slotting in Jimmy Garoppolo and now, I'm a Jimmy G. fan and now that Tom's retired, I can say that I'm done with the Bucs and supporting the Niners, tough loss the other day.

Todd: Well, I'm a Buffalo Bills fan so…..

Don: There you go. (both laugh)

Todd: It's going to get much tougher than that a couple of weeks ago. And then final question, biggest inspiration in life?

Don: Yeah. I'd say my Dad, taught me the value of hard work. He was a first gen college student, his Dad fought him over to sort of a cleaning force, a janitor at night causing my Dad to pay his way through school and ultimately became the CFO of a large public company. He raised me to work for everything that I have, I took on a lot of student debts to get through school and was raised to think that, you know, if you put your mind to it and you work hard then you can accomplish your dreams and so that's what we're trying to do here today.

Todd: Well, Don, I appreciate your giving me a few minutes and coming on the show. Tell the audience how they can find you and how they can find Arc.

Don: Follow us on Twitter @joinarc, add us on LinkedIn, we're at arctechnologies and feel free to reach out to me or my Co-Founders anytime, it's team@arc.tech

Todd: Alright. Well, Don, continued success, hopefully, you guys continue building that rocket ship that you talked about. Thank you for a few minutes and we'll get in touch sometime in the future.

Don: Thanks, Todd, great talking to you.

Todd: Thank you.

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