Financing your startup ..

.. the fundamentals with lessons from other Mudders

Rule no. 1: In the eyes of investors, it is better to have an 'A' team with a 'C' product than a 'C' team with an 'A' product.

(who am I quoting? every professional who has ever addressed this class)

The necessary components

- Management and legal team
- A plan of business
- Financing (typically a few million $)
- Product or service
- A deep knowledge of market
- A deep knowledge of competition

John Glanville, Atheaeum Capital Partners

What do investors want?

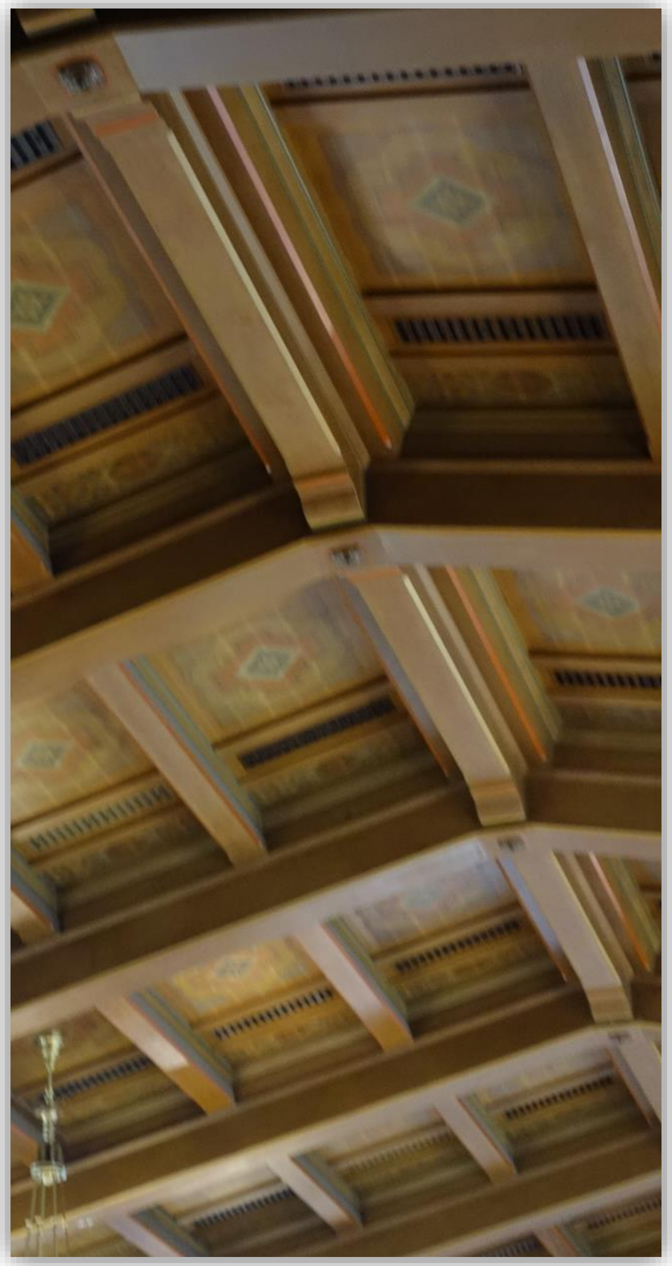
- Return on Investment

- Portfolio Diversification

- Risk versus Reward

- Intuition and the Odds of Success

John Glanville, Atheaeum Capital Partners



Differentiators

- Technology & Intellectual Property
- Service
- Distribution & Delivery
- Something Unique or Unusual About the way you do things.

John Glanville, Atheaeum Capital Partners

VC Deal Filters – The Wish List

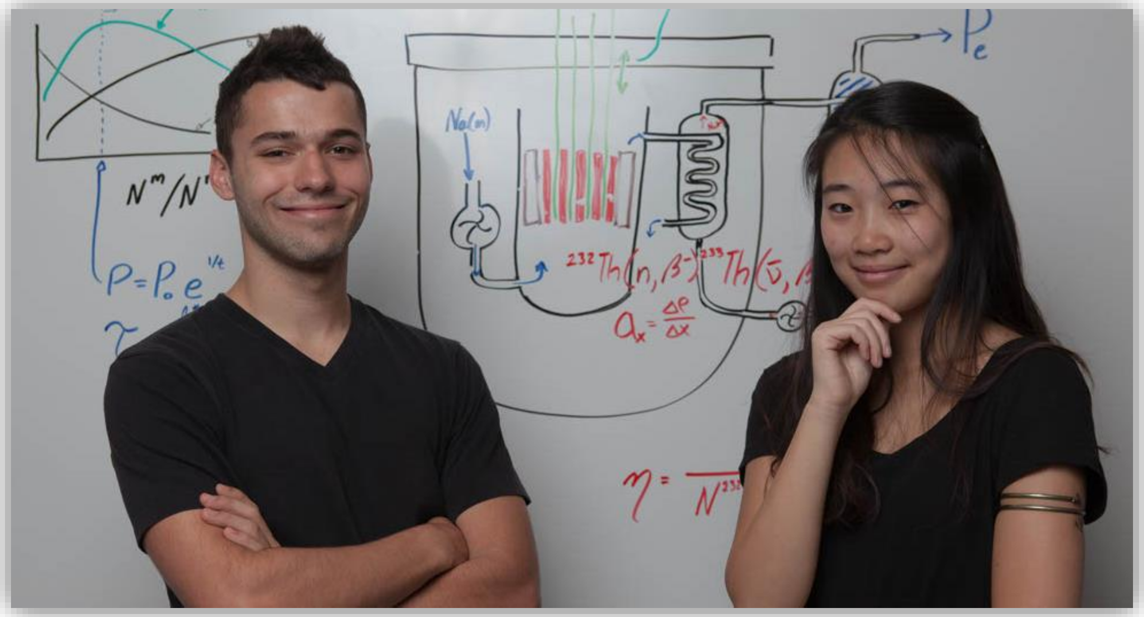
- Team (domain expertise, demonstrated ability to execute)
- Large, growing market ($100mm+ revenue opportunity)
- "Must have" product/service (value proposition)
- Unfair competitive advantages
- Business model (leverage, margins, path2p)
- Capital Need and Percentage Ownership
- Strong partners, board, investors
- Exit options

Dan Shapiro, Carl Coryell-Martin, Craig Owen

HoDong Nam, Altos Ventures

Fundraising Difficulties

- Wish list vs. reality
- Who is greedy, arrogant, don't understand markets, technology or people? The VCs or the entrepreneurs?
- Potential Conflicts
  - Partnership and Control
  - Inequalities, Valuation and Dilution
- Miscommunication
- Misunderstandings
  - Key concepts (idea vs. execution,
  - technology vs. business)
- Market Inefficiencies ???



Eric Kiss and Lisa Lam

HoDong Nam, Altos Ventures

Raising VC Money is a Process

1. Introduction
2. Initial Meeting
3. Due Diligence (understanding and getting comfortable with the risks)
4. Investment memo and the full partnership pitch
5. Term Sheets (who set the value)
6. Final Documents and Closing
7. Now the marriage begins…
8. Follow on rounds of funding
9. Liquidity (Exiting and Harvesting)

HoDong Nam, Altos Ventures

Final Advice on VC Fundraising (from Nam)

- Keep it Simple (Goal is to sell the VCs)
  - Be clear and concise and remember that it's not about the business plan (it's about execution)
  - 1 page executive summary, 10 slide presentation
  - Maybe: ~~20 page business plan~~
- Get the basics right
  - Keep in mind that the most goal is to build a great business, NOT to raise money (chicken or egg?)
  - Market Opportunity/Customers, People/Team, Product, Partners
  - Bottom line: are the dogs eating the dog food? ???
- Do your homework on the VCs and have proper expectations
  - Understand the process and who you're selling
  - Analyze the financing alternatives, trade-offs and make a decision
  - Control, Dilution, Point of no return…

HoDong Nam, Altos Ventures

Financial instruments found in the term sheet …

Aaron Lamb, InnoCom, Chas Wurster, Tourmaline CTO

- **Common stock**
  - Simple shares, often one share, one vote, priced per share, equal rights.
  - This is usually how it ends up, but not how it starts (will not be in term sheet)
- **Preferred convertible stock**
  - Convertible to common at some trigger point, often the exit, 1 to 1 or maybe not.
  - Preferred gives it liquidation and other privileges not offered to common holders.
- **Convertible debentures**
  - Convertible to common stock at some trigger point, often the exit, for stipulated shares.
  - A debenture is a loan, so this is technically a convertible extension of credit.
  - Has superior liquidation privileges, even over preferred convertible.
- **Warrants and options**
  - A secondary part of the contract that offers first right to buy more stock in the future.
  - Warrants detail (a) amount of common allowed, (b) when, and (c) at what price.
  - The rights are extended with “cliffs,” which are time intervals.
  - Price is low and is often the same price as the original sale if it was common.
  - A huge incentive for private investors.

Valuation … the big issue.

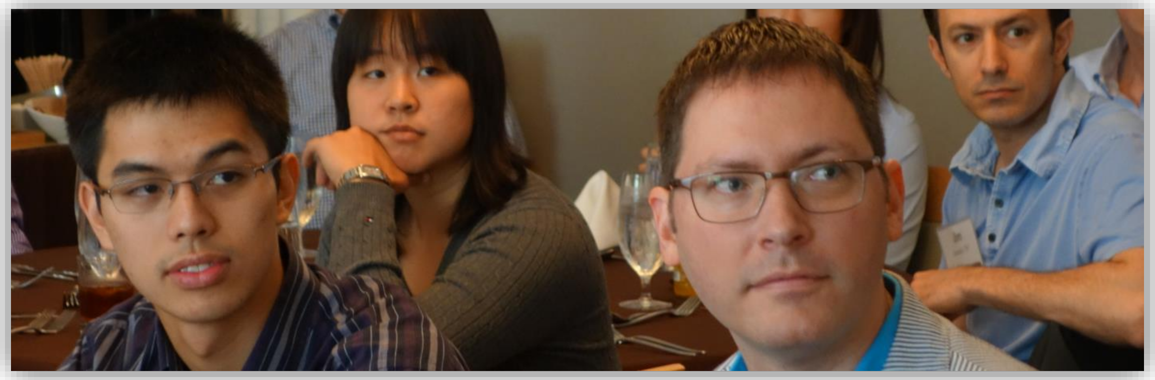
Here are two terms that you should know:

- **pre**-money valuation: the product of the total number of shares outstanding times the most recent pricing of your stock (i.e. 400K shares times $0.50 = $200K) **before** you have raised money with this round.
- **post**-money valuation: the product of the total number of shares outstanding times the current offered price for your stock (i.e. 600K shares times $2.00 = $1.2M) **after** you have raised money with this round.

Often valuation is explicit … HMCINQ offers $120,000 for 8% equity stake, which implies a psm of $1.5M.

There is no hard and fast rule about how you approach valuation or share price you when negotiate with professional funders. IMHO you should have an idea about what you want, but not state it unless they demand it, and wait for them to offer you a term sheet.

Ivan Wong and Greg Rae



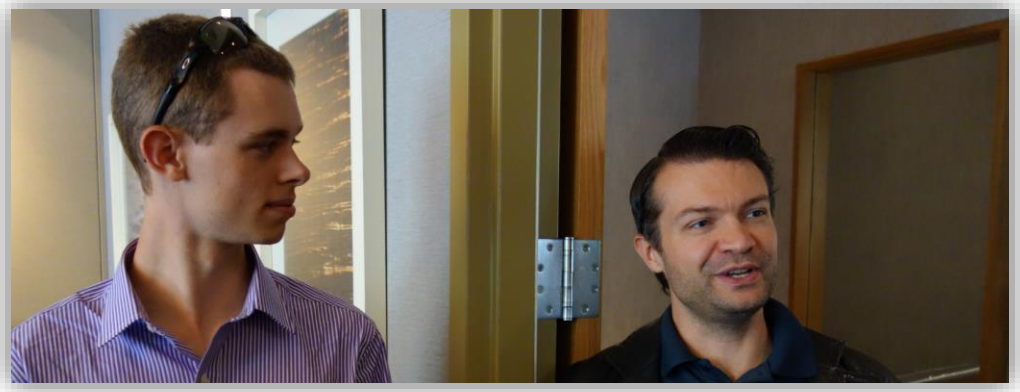
Dilution

... how it works

At each new stage of financing, including the IPO, new investors are brought in by issuing new stock to them from the pool of authorized stock.

Therefore, the number of shares owned by previous investors does not decline, but their percentage of the total does. A initial investor with a 35% 1 million share stake in a startup, after two stages of investing might still own 1 million shares, but only 10% of the company.

Dilution



Sean Messenger
and Ian Erickson

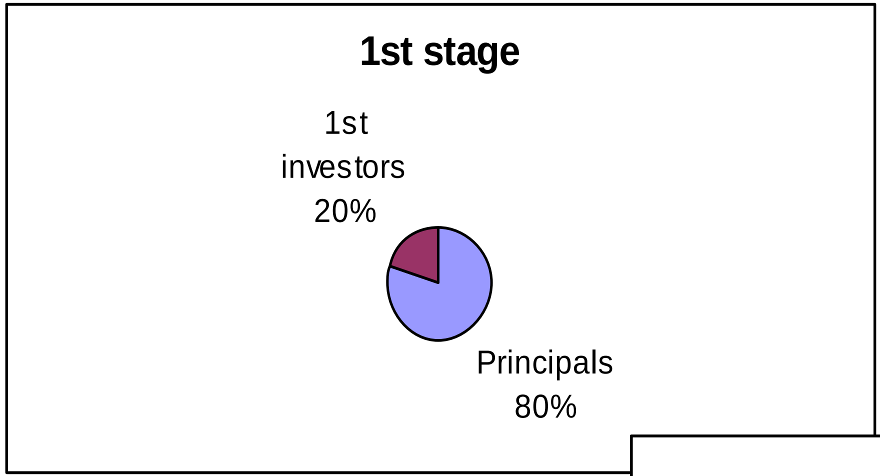
… why it is necessary

Any investor or principal in a startup must understand and be willing to accept dilution. Why?

Obviously, dilution is how you raise money. New investors insist on an equity share of the company and dilution is how it must be done. The tradeoff between $$ invested and the share the new investor gets is, of course, negotiated.

Remember: far better to own 30% of a $100,000,000 market cap than 80% of nothing.

Dilution: simple example



Principals given 4 mill shares, initial investors buy 1 mill shares for $1 mill.

A few months later new investors pay $6 mill for 3 mill shares.