Considerations in StartUp Finance

Basics Of Finance

Paan-Walla Finance

- Revenue; Cost of Goods Sold; Gross Profit; Sales, Marketing, Other Expenses; Profit

  Cash vs Profit
  Cash vs Accrual

Apple Finance

- Income Statement: http://www.nasdaq.com/symbol/aapl/financials?query=income-statement

  Cash Flow Statement: http://www.nasdaq.com/symbol/aapl/financials?query=cash-flow

Aspects of negotiation

- Start with Friends and Family or “Angels”
- VC Negotiation is not a Perfect Science
- Financial Aspects of Negotiation
- Non-financial Aspects of Negotiation

Aspects of VC calculation

- Valuation assuming no Dilution
- Valuation assuming Future Dilution
- Conversion to Current Ownership and Prices

Aspects of negotiation

Negotiation is not a Perfect Science

- Negotiation involves an overall strategy that encompasses Relationship, Process, Value, Options and Economic Logic
- Though each of these may vary, behavior is the most unpredictable and styles vary. Emotions such as pride, worry, disappointment can influence behavior and hence outcomes. Keep in mind interests of others
- Founder's ability to influence varies widely and can make or break a deal
- VC's and Founders goal vary, each wanting to make the most of the situation
- Everyone makes mistakes given the complexity and emotions involved in a deal

Aspects of negotiation

Non-financial Aspects of Negotiation

- **First and foremost understand your bargaining power (levers)**
  - For example: How many firms are interested in your start-up? Greater the number, greater is your leverage. The IP you may have is an important lever. Other levers could be any customers you may have lined up. Use your leverage to get the terms that are most important to you. If you don't, once the deal is signed you cannot take advantage of the discarded alternatives.
- **Know your financing options**At any given point in time know what your financing options are. Not knowing your options can put you in a weak position to bargain or ask for additional financing. Most overlooked options are: Strategic partnerships, Bridge loans and additional venture capital
- **Start early**
  - If you think you may run out of money, don't wait till the last moment to get additional financing, you may end up with the most expensive or least desirable terms on your financing.
- **Right size your financing request**
  - Many a times founders are very optimistic, have too much confidence in their business model, poor judgment on calculating their burn rate and do not provide for contingencies. As a result they do not provide for enough funding during early rounds as a result may run out of money
- **Trust – a double edged sword**
- **Act ethically**

Non-financial Aspects of Negotiation

- **Understand your bargaining power (levers)**
- This is very critical for success in negotiating. Many startups ignore crucial sources of power and put themselves in a weak position to bargain.
- Some of these levers are:
  - Number of VC firms interested in your start up. Greater the number, greater is your leverage
  - Your IP
  - Customers you may have line up/pre-sales, existing sales.
- Use your leverage to obtain the terms that are most important to you. If you don't, once the deal is signed you cannot take advantage of these discarded alternatives. Any leverage you may have going forward will have to come from other sources.

Non-financial Aspects of Negotiation

- **Right size your financing request**
- Many a times founders are very optimistic, have too much confidence in their business model, have poor judgment in calculating their burn rate and do not provide for contingencies. As a result they do not provide for enough funding during early rounds. This can put you in a weak bargaining position when the money does run out.
- Getting a slightly bigger first round than necessary or pre-negotiating conditions for bridgeloans or additional financing is a good idea.
- **Know your financing options**
- At any given point in time know what your financing options are. Not knowing your options can put you in a weak position to bargain or to ask for additional financing.
- Some of the most overlooked options are: Strategic partnerships and Bridge loans, both can help prevent dilution

Non-financial Aspects of Negotiation

- **Running out of cash**
- After taking all precautions, if you think you may run out of money, act fast. You may end up with few alternatives, most expensive financing or least desirable terms. VCs may take advantage of your position and offer low valuation and take a greater portion of your company.

Maximize trust and acting ethically

VCs put a premium on trust. If a situation changes such as a key employee leaving or a strategic partnership breaking down disclose that as soon as possible. VCs would rather work with partners they can trust rather than those who are untrustworthy.

VCs expect you to ask for better terms, comparison shop and use whatever levers you may have, but not after you have reached an agreement. If you act unwisely or unethically they may call off the deal.

Non-financial Aspects of Negotiation

- Valuation and Control
- Founders put disproportionate emphasis on valuation and not enough on retaining control of the companies they are building. Valuation would not matter as much in the long run but diminished control of the company can last forever.

Aspects of negotiation

Critical Financial Aspects of Negotiation

- **Liquidation Preference**
  - This gives the VC firm the priority over founders to recover their investment or a set multiple at the point of sale or at any liquidation event(s)
- **Participation**
  - Entitles the VC to share the value that remains once the liquidation preference has been paid out.
- **Why are these critical?**
- These two terms determine what the founders will be left with on liquidation. It also reminds you that focusing only on the valuation and ignoring other aspects such as these can be detrimental to the ultimate goal.

Aspects of negotiation

Critical Financial Aspects of Negotiation: Liquidation Preference and Participation

- Assume that the VC invests $1 M in a startup for a 25% stake in the a startup (implying a valuation of $4M) and negotiates a 2x liquidation preference and full participation rights
  - Sale Price: $10M
- Liquidation preference = Investment X multiplier
  = 1 X 2 = $2M
- Participation = (Sale Price – Liquidation Preference) X Ownership%
  = (10 – 2) X .25 = $2M
- VCs total share = $4M or 40% of sale value in spite of a 25% stake in the venture.
- Founders share = $6M

Aspects of negotiation

Critical Financial Aspects of Negotiation: Liquidation Preference and Participation

- **If the company did very well and sold for $100M**
- Liquidation preference = Investment X multiplier
  = 1 X 2 = $2M
- Participation = (Sale Price – Liquidation Preference) X Ownership%
  = (100 – 2) X 0.25 = $24.5M
- VCs total share = $26.5M or 26.5% of sale value which is closer to the 25% stake in the venture
- Founders share = $73.5M
- **Note that in both illustrations the original valuation of $4M has little bearing on the final distribution**.

Aspects of negotiation

Key Factors

- Valuation
- Capital Structure (equity and debt)
- Protecting the Investment
- Anti Dilution Provisions
- Performance/Forfeiture Provisions
- Employment Contracts
- Control
- Shareholder Agreements
- Disclosure
- Registration Rights
- Liquidation and Merger Provisions
- Modification Rights

One More Thing…

SAFT; Token Sale; ICO

- What are Token Sales
- What is an ICO
- How Does One Do it
- SAFE
  - A **safe** is a Simple **Agreement** for Future Equity. An investor makes a cash investment in a company, but gets company stock at a later date, in connection with a specific event. A **safe** is not a debt instrument, but is intended to be an alternative to convertible notes that is beneficial for both companies and investors.
- SAFT
  - Simple Agreement for Future Tokens.

Glossary Of Terms

What they say	What they mean
1. We conservatively project	1. We looked at a book - $50M
2. Best guess/2	2. We accidentally divided by 0.5
3. We project a 10% margin	3. Left downloaded template as-is
4. Project 98% complete	4. Remaining 2% will take as long, but cost twice as much
5. Business model is proven	5. Evidence from last week, one instance and extrapolate
6. We have a 6 month lead	6. Tried not to find others with 6 month lead
7. We only need a 10% market share	7. So do the other 50 entrants
8. Customers clamoring for product	8. Havent asked them to pay for it
9. We are low-cost provider	9. Havent produced anything but are confident
10. We have no competition	10. Only IBM, Microsoft, Twitter and Facebook
11. Mgmt team has a great deal of experience	11. …consuming the product or service
12. Select investors considering plan	12. Mailed a copy to many investors
13. We seek value-added investor	13. Looking for a passive dumb investor
14. If you invest on our terms you will realize a 68% IRR	14. I everything goes right you might get your money back