

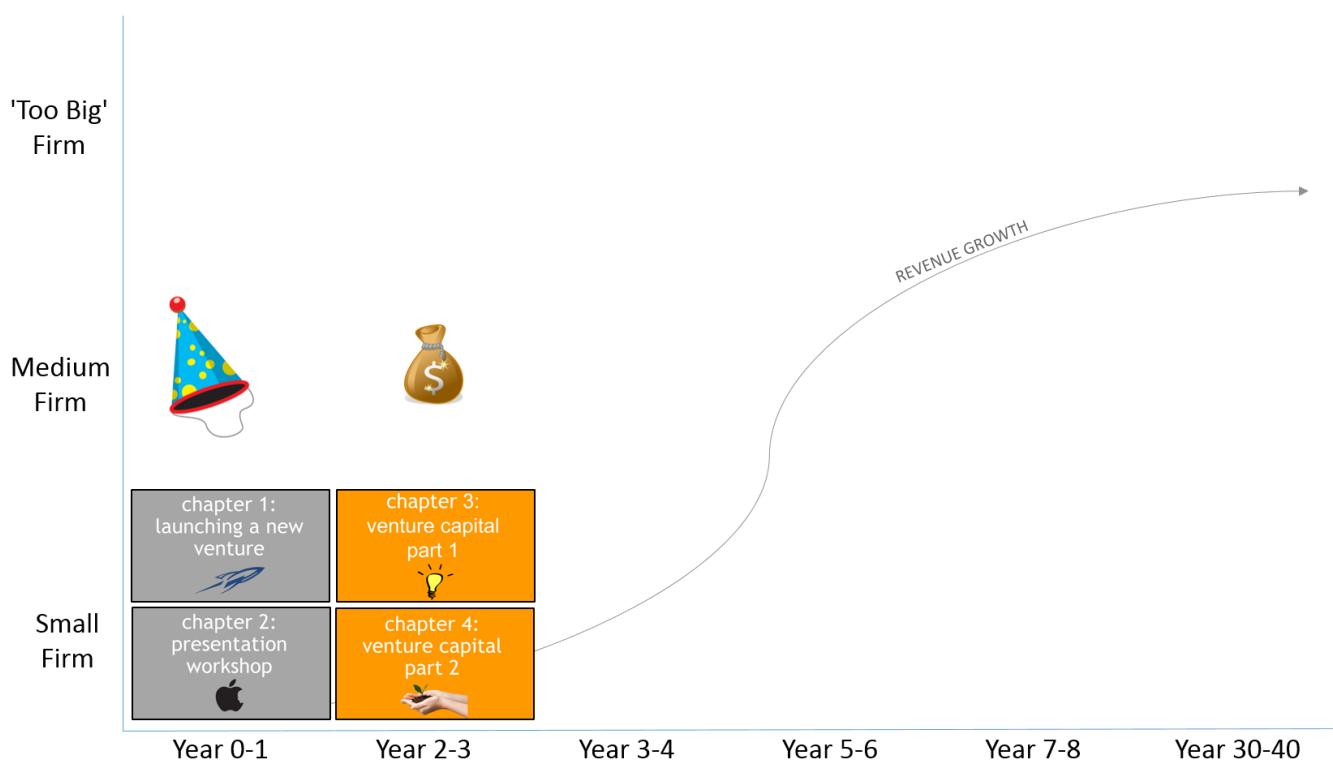
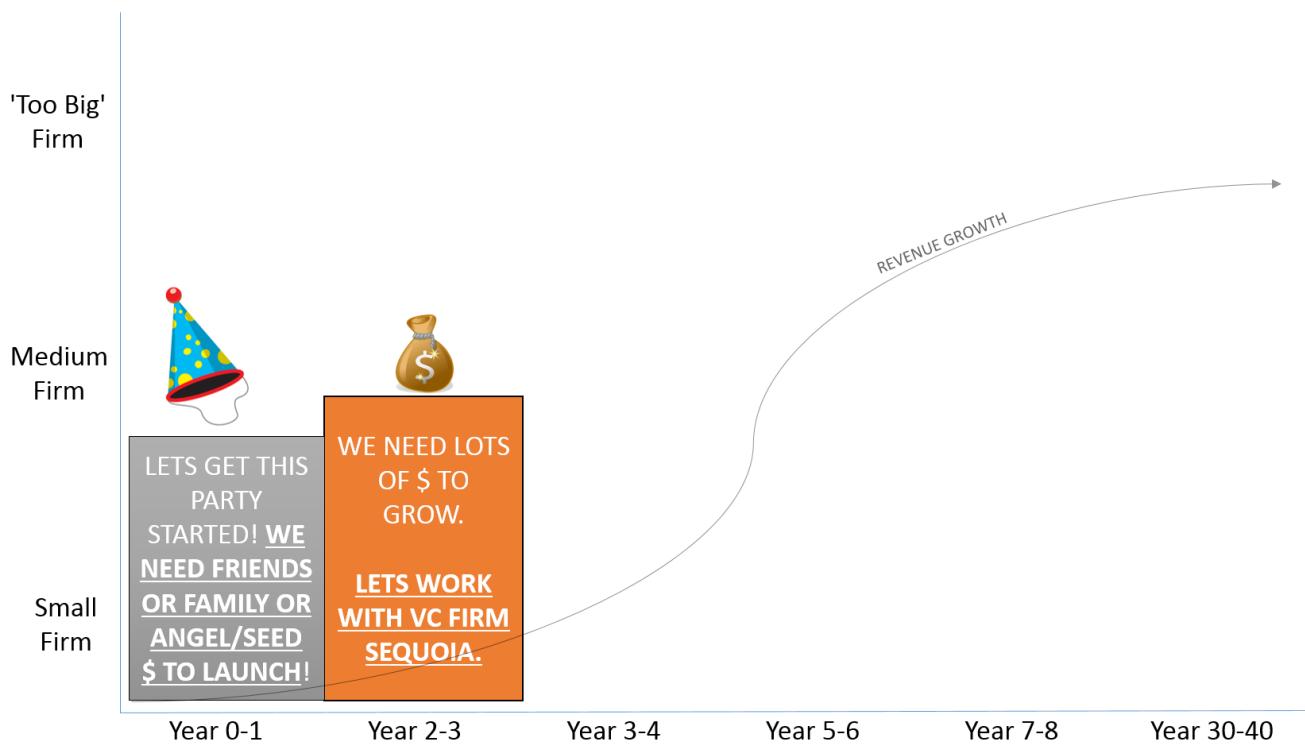
CHAPTER 4: VENTURE CAPITAL PART 2

“Only those who dare to fail greatly can ever achieve greatly.”

- Robert Kennedy

chapter 4:
venture capital
part 2





THE FASCINATING HISTORY OF VENTURE CAPITAL

In order to understand the brilliant minds of commerce, including Steve Jobs, Andy Grove, John Doer, Bill Gates, Mark Zuckerberg, Larry Ellison, Marc Benioff, Doug Leone, Andy Bechtolsheim, and other Silicon Valley legends, we need to understand why Silicon Valley is the birthplace of so many incredible companies. Why is it relevant? Shouldn't Boston be more relevant with MIT, Harvard and other great schools? Shouldn't London be more relevant given Oxford, Cambridge and other great schools? What is it about Silicon Valley that makes brilliant drop outs like Steve Jobs and Mark Zuckerberg so successful?

We need to do a deep dive on the genesis of Silicon Valley to really understand what drives entrepreneurs in this region and what we can learn from them. This chapter and Silicon Valley is where *technology meets the liberal arts...*

The most successful people in business think different. They challenge conventional wisdom and authority and the way things are done. They don't care what others think about them. They are pioneers. They are passionate. They are positive and often criticized; they believe that unjustified criticism is a disguised complement...and so they welcome criticism and thrive on it.....I love that! They are my business heroes and we will learn about what drove/drives them in this chapter.

This will be a highly entertaining chapter. A video version of this chapter can be accessed online at www.tiny.cc/chris37.



Silicon Valley is relevant today because of many different 1960's conflicts, including the following:

- The conflict between the USSR and the USA.
- The conflict between those in favor of and those against the war in Vietnam.
- The conflict between those over 30 and those under 30. A popular hippie saying then was "don't trust anyone over 30".
- Those in favor of drug use and those against drug use.
- Those in favor of free love and those against it.

the dna fabric of america is based on extremes*.



* not a criticism as I do love this country.



**VC IN AMERICA
WAS BORN DUE TO THE
COLD WAR**



part 1

part 2

part 3

There are 3 parts to this historical chapter on venture capital. We will start with War (Part 1).



part 1

in order to understand vc, we need to understand the genesis and historical context of the geopolitical events that caused the vc sector to emerge....

yes...american fear of russia
is the only reason the vc industry
exists.

the post ww2 catalyst that
created vc was both:

war & peace

the post ww2 catalyst that
created vc was both:



&



是. competing with russia is the
only reason the vc industry
exists.

fear and the cold war led to
the creation of the internet.

all of these brands exist because
of government funding of
weapons to compete with russia.



The underlying technology behind all of the aforementioned brands was based on government funding of military based technology research projects.

We have overtaken you in rockets

We will overtake you
in color television too

america was humiliated and
terrified of russian military might.

so america invested in weapons
research....which led to the
invention of....

gps was from
guided missile research



the database exists because
of the cia's project oracle.



the microchip was financed by nasa



WAR

palantir [largest employer in palo alto] was financed by the cia's vc division.

WAR

Most people don't realize that the largest employer today in Palo Alto is not Facebook. Palantir (www.tiny.cc/chris39) is now the largest Palo Alto based employer. Palantir makes an extremely sophisticated software program that solves many of the world's most complex problems. In fact, a significant reason that the Obama administration was able to find Osama bin Laden was because of the use of Palantir.

the web was built in case soviet nuclear bombs hit our major cities.....

...then cities could still communicate with other cities via different traffic routes

WAR

是. competing with russia is the only reason the vc industry exists.

WAR

Мы вас похороним!



‘we will bury you!’

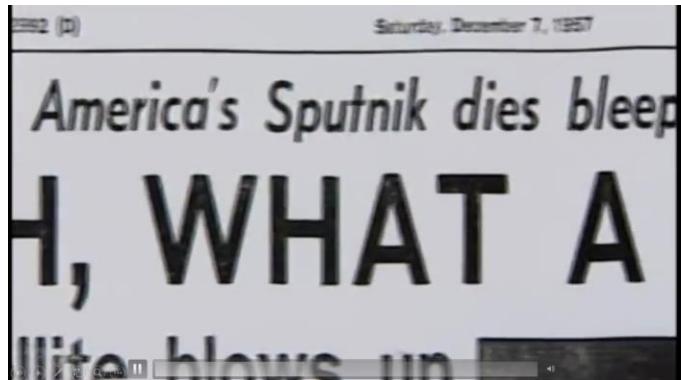
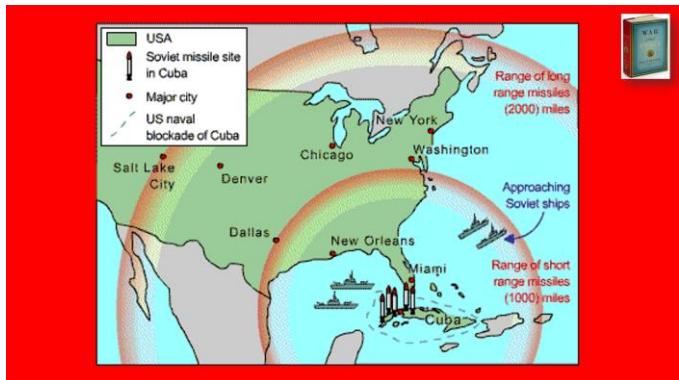
WAR

russia had nukes in cuba....

the us almost launched nuclear missiles...

WAR

Russia put weapons in Cuba and almost started World War 3. Khrushchev told America we will bury you.
www.tiny.cc/chris38



America was worried about the Soviet Union's superior rocket technologies and military might. Russia's 'Sputnik' rocket beat America's rockets to space. National pride was a significant issue in the 1960s for America for so many reasons, including the cold war, many assassinations etc. America needed to get a person on the moon before The Soviet Union.



as kids we were trained to expect nuclear bombs to fly over canada and hit the us.

Growing up in Canada we were warned that Soviet nuclear missiles would fly over Alaska and Canada en route to America. The media was in on it too.

vc and government weapons research was a top focus...

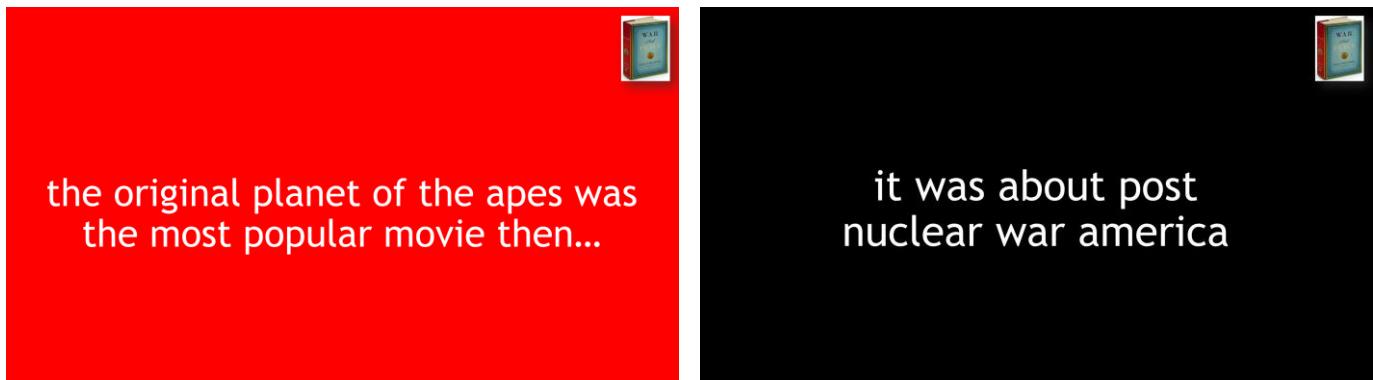
...partially due to influential [and dumb] government commercials like this:



My mom told me they saw “duck and cover” commercials on television when they were children like the absolutely ridiculous one listed above: www.tiny.cc/chris41



Our teachers sent letters home to our parents in Canada warning us of the movie that was going to air on our networks: www.tiny.cc/chris42



During the peak of the cold war in the late 1960s, a post nuclear America was the most popular movie.....the end scene was epic and frightening: www.tiny.cc/chris43





part 2

Peace (part 2). Fortunately, the hippie movement in the San Francisco Bay Area influenced the rest of the nation to embrace peace instead of war: www.tiny.cc/chris44

<p>in the late 60s an amazing thing happened...</p>	<p>youth in san francisco rebelled.</p>
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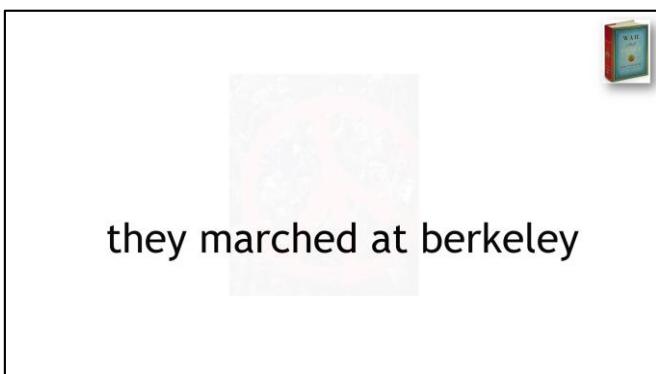
<p>they chanted make love not war</p>	
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The ‘summer of love’ had a profound impact on those coming of age in the 1960s, including Steve Jobs and many other tech sector legends. www.tiny.cc/chris45



Berkeley's hippies changed America and the world. www.tiny.cc/chris46



Riots spread across America as the clash between those in favor of conflict and those that didn't reached an all-time high: www.tiny.cc/chris47



they marched at stanford



they held peace events in sf at telegraph tower



they shared everything.



stanford got rid of all government weapons research on campus (which was 50%+ of their r&d budget at the time)

shareable open source software was born.



even universities like stanford let their students and teachers share ideas and make money from it.



the counter culture movement was born.

they experimented with drugs

they didn't trust anyone over 30

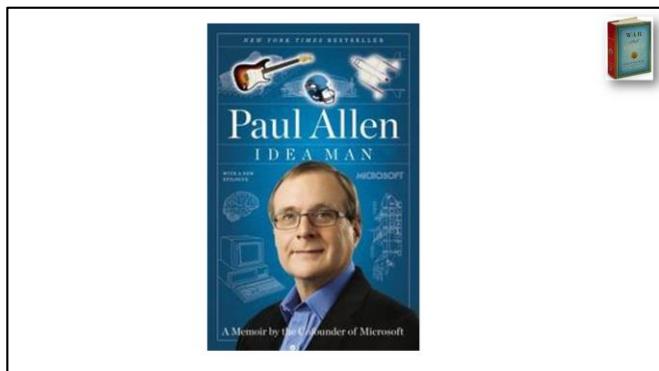
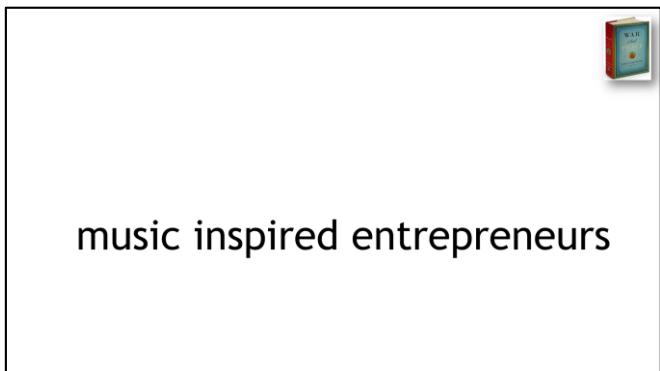
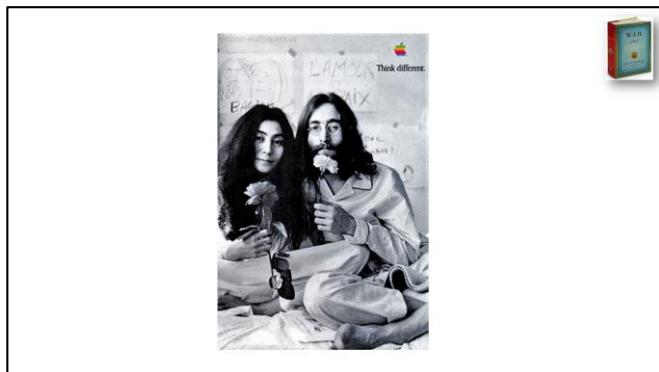
their family and friends were dying in vietnam fighting a bullshit war they couldn't win or understand.

inspired by music

which led to the invention of the personal computer.

they hated the war focused movement of the day.







these entrepreneurs were former hippies and they thought differently from their parents.



they thought differently and embraced change (thank God)

inter racial marriage was illegal in 13 states in the 60s. WTF!



on the ‘left’ coast they thought “hey man, it’s cool to fail... just keep trying”

these heroes were ready to share ideas and change the world.



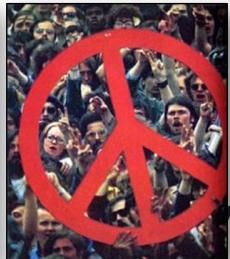
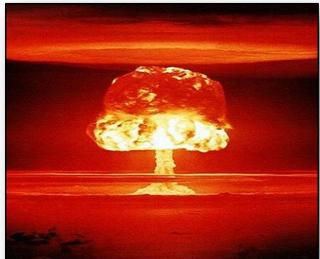
here it’s cool to be and think different as all ideas are accepted here.



a fertile tigris and euphrates technology crescent was born out of evolution and revolution.

these big bang unique events haven't occurred anywhere else in the world yet....

and only took place because america is a country of extremes





part 3

vc history...let's put this
puzzle together!



Sunday Evening, October 5, 1957

UPI-McNees United Press

PRICE FIVE CENTS

Russians Win Race To Launch Earth Satellite

Man On Threshold Of Space Travel

By DANIEL F. CHAMORE
United Press Staff Correspondent

LONDON (UPI)—The pulsating radio "beep" of the first manmade earth satellite signalled today to the world that man had crossed the threshold into the age of travel through space.

The Soviet Union announced it had won the race into space by launching an earth satellite Friday, a 184-pound, 22-inch sphere now orbiting the earth at 18,000 miles an hour, 260 miles up.

Millions of persons throughout the world heard the "beep," rebroadcast today by local stations and realized that man had indeed reached another milestone into the new era.

Last night's satellite was a tremendous victory for Russia. It was the first step toward her goal of being able to trumpet to the world the Russian message of communism through the frontiers of space.

Believe it or not, the satellite claims to

— WEATHER —

WEST VIRGINIA—Partly cloudy to 50 percent chance of rain Saturday. High 60°. Low 40°. Sunday. Lowest tonight, 36° with 40° east northeast.

Low pressure system will move west and north and 50 to 60 percent chance of rain Saturday. High 60°. Low 40°. Sunday. Lowest tonight, 36° with 40° east northeast.

Tides on the coast and lower bay will run a foot or two above normal.

By JOSEPH J. MYLEB
United Press Staff Correspondent

WASHINGTON (UPI)—American scientists caught platformed Russia's first launching of a satellite last night and predicted the United States may speed its own launching of a satellite.

Leaders of the U.S. aerospace team said they would pick up several more observations of the satellite.

Through optical instruments the satellite looks like the planet Venus, which can be seen with the naked eye.

It is too small to be seen with the naked eye. The satellite travels so fast it may not appear on the horizon for only a few seconds because of the speed. It has been estimated at one in a hundred.

This could mean Russia has beaten the country.

Russia's launching of a satellite has been called the "30 weapon." This country has tested a successful ICBM.

Russia's launching of a satellite has scored a notable victory. The milie

the richest* family in america...



[*they owned exxon]

they have a vc division called:



venrock invested in fairchild semiconductor



The government created NASA with the intent of putting the first person on the moon. They couldn't do so as they needed to fit many transistors in the fuselage or top portion of a rocket. Fairchild Semiconductor was the Bay Area start-up that was successful in building these chips!



these 8 folks are called “the traitorous 8” and they founded Fairchild semiconductor and CHANGED THE FN’ WORLD!



the company got too big!!!!

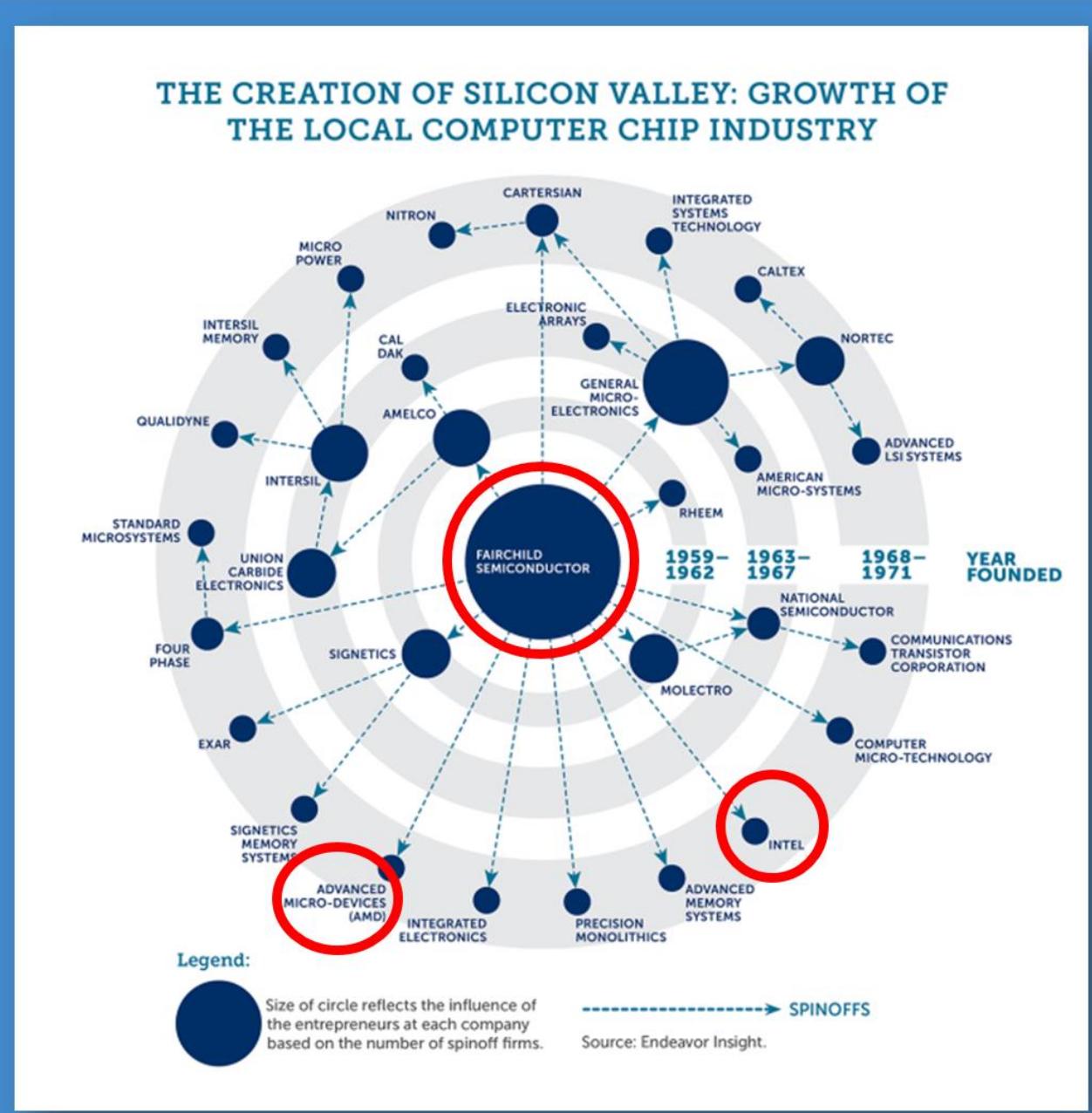
As with all great technology companies, eventually they get bloated and bureaucratic. As a result, they can no longer innovate (especially if the founders resign).



and therefore couldn’t innovate!



and so many quit....

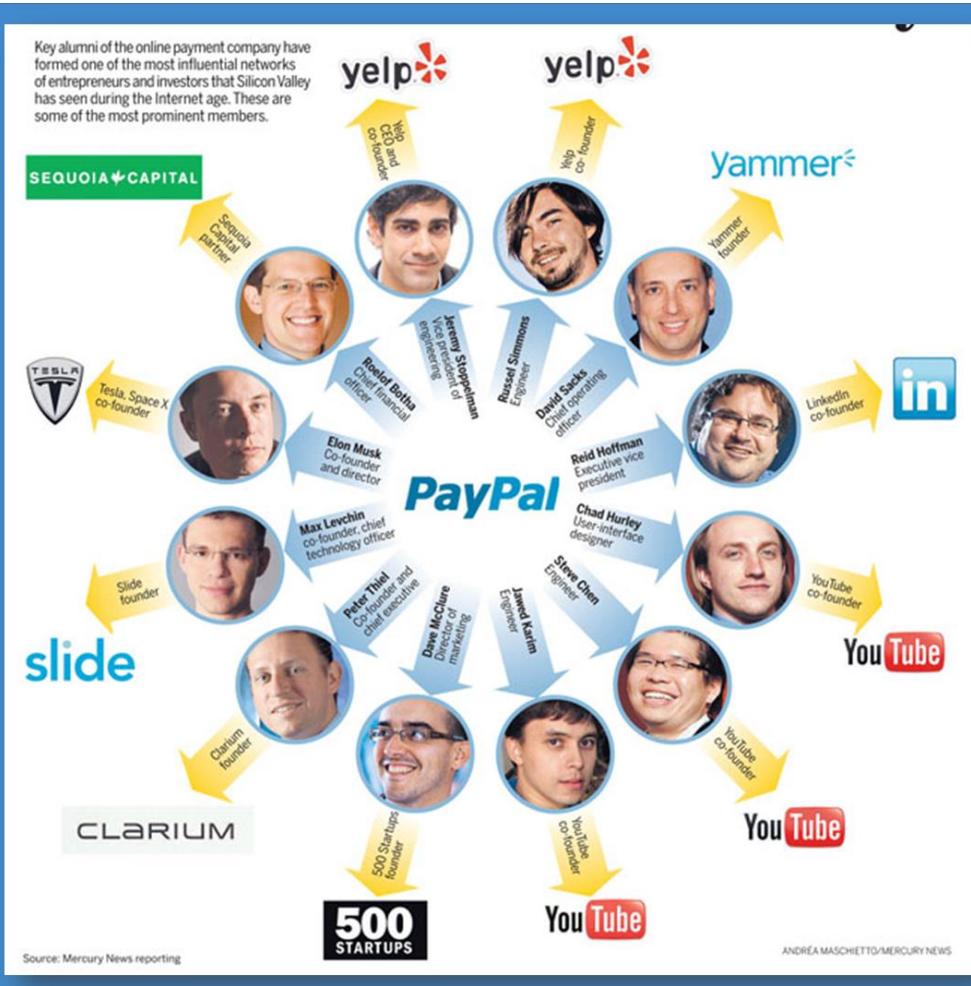


Fairchildren companies include Intel, AMD and NVIDIA.

in the internet space, VCs backed the paypal mafia!



PayPal is the most important technology company to go public in the past 20 years because out of PayPal came many incredible companies. Including the founders of YouTube, Yelp, Tesla, SpaceX and many more. Similar to the 1960s hippie heroes, Peter Thiel (the cofounder of PayPal along with Elon Musk) believes in decreasing government authority. His libertarian political views via PayPal intended to disintermediate government authority by creating a form of payment that governments could not regulate. Take away a government's ability to alter monetary policy, and take away its most important weapon (the ability to print money in order to fund government projects or to stabilize economies etc.).



vc firms love backing the same executives again...

In the public markets, there is a notion that 'past performance is not indicative of future performance.' In the private markets it is though - if you have an incredible management team. A founder that has started and sold multiple successful start-ups has a much higher probability of being successful in the future. As a result, venture capitalists prefer to invest in solid management teams (ahead of solid ideas). For some reason, public market investors don't spend enough time analyzing management teams. The jockey is always way more important than the horse with all investments.



the top vc firms get all the great deals.

The top venture firms continually get access to the best deals. In the next few pages are websites and corresponding venture capital investments for these top vc firms. We will kick it off with Kleiner Perkins:

The screenshot shows a Microsoft Edge browser window with the URL www.kpcb.com/companies. The page features a dark header with the KPCB logo and navigation links for 'Sign up for our newsletter' and 'SIGN UP'. Below the header, there's a sidebar with a 'Public / Acquired' section containing categories: Consumer Digital, Enterprise Digital, Life Sciences & Digital Health, and Sustainability. The main content area displays a grid of company logos, each with a 'View website' link below it. The companies listed are: myfitnesspal, LendingClub, FLEXUS BIOSCIENCES, nest, FOUNDATION MEDICINE, dropcam, waze, Google, zynga, amazon.com, OPower, LuxVue, TESARO, MANDIANT, and EA ELECTRONIC ARTS. At the bottom of the browser window, the taskbar shows several open files: '02 - 21st Century B...mp3', 'iTunes6464Setup.exe', 'The Day After 1983mp4', and 'Show all downloads...'. The system tray at the bottom right shows the date and time as 7:36 PM on 6/12/2015.

The screenshot shows a Microsoft Internet Explorer window with the URL www.accel.com. The page displays a grid of logos for various portfolio companies. At the top, there's a navigation bar with links for 'Companies', 'About', 'Blog', 'People', 'Locations', and social media icons for search, Facebook, and Twitter. Below the navigation bar, the 'ACCEL PARTNERS' logo is prominently displayed with the tagline 'BROWSE ALL COMPANIES'. The grid of logos includes:

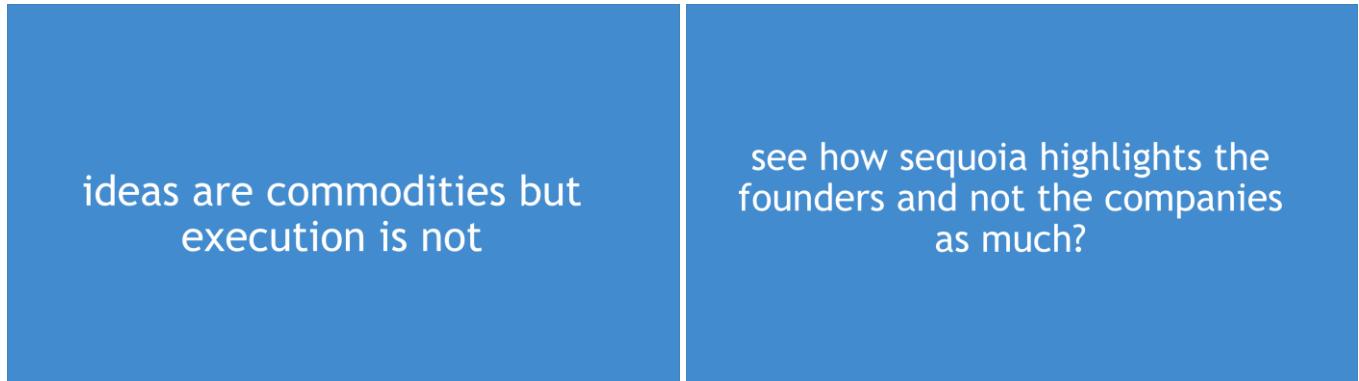
- 99designs
- Atlassian
- cloudera
- Dropbox
- Etsy
- facebook
- flipkart
- KAYAK
- lynda.com
- Spotify
- SQUARESPACE
- SUPER

Below the grid, the taskbar shows several open files: '02 - 21st Century B....mp3', 'iTunes6464Setup.exe', and 'The Day After 1983mp4'. The system tray at the bottom right shows the date as 6/12/2015 and the time as 7:36 PM.

The screenshot shows a Microsoft Internet Explorer window with the URL www.greylock.com/greylock-companies/. The page displays a grid of logos for various portfolio companies. The navigation bar includes links for 'TEAM', 'COMPANIES' (which is currently selected), and 'NEWS'. The grid of logos includes:

- greylockpartners.
- COMPANIES
- ALL
- CONSUMER
- ENTERPRISE
- airbnb
- APPDYNAMICS
- APPTIO
- AQUANTIA
- Arista Networks
- AtHoc
- Avi Networks
- Bounty Jobs
- clearslide
- cloudera
- Constant Contact
- Microsoft

Below the grid, the taskbar shows several open files: '02 - 21st Century B....mp3', 'iTunes6464Setup.exe', and 'The Day After 1983mp4'. The system tray at the bottom right shows the date as 6/12/2015 and the time as 7:37 PM.



A screenshot of a web browser displaying the Sequoia Capital website at <https://www.sequoiacap.com/us/technology>. The page features a navigation bar with links to About, Founders, Team, Jobs, and Grove. Below the navigation is a search bar. The main content area displays a grid of black and white portraits of various founders, each associated with a company name: [24]7, 3Com, 6Wunderkinder, Abrizio, Achievers, Agile, AgilOne, Altiscale, App Annie, Appirio, Steve & Steve, Aricent, FORTUNE Confessions of a CEO Aruba, Aspect Development, Aster Data, Atari, Barefoot Networks, Bluebeam, and Pong. To the right of the grid is a green sidebar titled "TECHNOLOGY" which reads: "We team with technology startups that engineer carrier infrastructure, data, enterprise infrastructure, open source, saas, security, semiconductors, services and storage." At the bottom of the browser window, the taskbar shows several open files and system icons.

most vc in america is in the bay area



the industry is highly cyclical

external events = bubbles burst



60% of engineers in the valley are born overseas.

no limits to what they (you) can achieve here.

dream.



today feels a bit like 1999.



Valuations are lofty for many venture backed companies today, but not nearly as egregious as what we saw when the last VC cycle peaked shortly after 1999 when Pets.com was still in business. When rates rise (and they will) then investors will likely invest in other asset classes. That being said, the best investors have a very long term investment time horizon and aren't easily influenced by long term economic cycles.

What Buffett is saying is common sense of course...but being a contrarian in the investment industry always pays off.

worth repeating!

“be fearful when others are greedy and greedy when others are fearful.”

-warren buffet

If you are looking for your company to get funded by a venture capital firm, it is imperative that you pick the right VC firm to partner with, otherwise you cannot be successful. Make sure the VC firm is early stage if your business is too. If you raised seed money and you are now looking for an A Round VC investor, then target a superb earlier stage VC firm like Sequoia or Kleiner. If you are closer to your initial public offering (IPO) and you want to do one more late stage D or E round, then try to work with the best late stage venture firms like Meritech, who have a great reputation and are fantastic trustworthy people too.

what vc should you target?

- ✓ are they founder friendly?
- ✓ are they growth or value?
- ✓ do you enjoy their company?
- ✓ do you trust them?

what vc should you target?

- ✓ know their stage focus
- ✓ know their sector focus
- ✓ know their reputation
- ✓ know their target return date

To state the obvious, don't approach venture capital firms or partners at these firms that don't cover the market that your company operates in. Also, make sure the VC firm that you partner with has an impeccable reputation of helping founders grow their company (instead of being activist disturbers in board meetings.... "lead, follow or get out of the way" to quote Ted Turner).

Make sure the venture firm that is going to finance your company's growth has a similar view on their target return on investment period. If your business won't likely do an IPO in 7-10 years, then make sure you pick a patient, long-term focused VC firm to work with.

If your gut tells you not to trust them (even after a brief first meeting), then chose to partner with another venture firm. Your gut impression is right more often than not, when it comes to who to partner with in business.

Make sure the VC firm is growth oriented (most are) instead of value focused if your firm isn't going to be profitable for many years. There is nothing more stressful than having differing expectations of business goals than your investors do.

Most venture capital firms charge their investors a 2% annual management fee (to pay for salaries, rent etc.). Venture firms make most of their money, though, through a 20% incentive fee that they collect after they are profitable (as we covered in more detail earlier in this book). The "2 and 20" economics of the VC sector is commensurate with how the hedge fund industry works. The difference between

how does investing in vc work?

- ✓ capital calls
- ✓ 20% left over to avoid dilution

the two sectors is that the hedge fund market is incredibly short-term focused and the venture capital sector is incredibly long-term focused.

When you invest your money in a venture capital firm, you don't give your entire agreed upon investment amount to the firm right away. Instead, they call you and ask for the capital as they need it. This is called "a capital call." Venture firms will call you when they need to deploy the capital. Let's look at an example. Let's assume you are an "accredited investor", meaning you have a very large liquid net worth and are allowed to invest in a venture capital firm. You agree to invest \$100,000. The hypothetical venture capital firm you are investing in has a risk management policy of never investing more than 10% of their fund in any one particular company. Then one month after you agree to invest your \$100,000 in the venture firm their CFO calls you and informs you that they are making a 10% (of their fund) investment in a company. They call you and ask for you to wire them \$10,000 of your \$100,000 investment. They will keep calling you and asking for money until about 80% or 90% of your capital has been invested or called for. The 10%-20% of your money that has not been called for is left over in case another venture capital firm invests in a company the VC firm you invested in at a future round. This is to offset your percent ownership in a company from being diluted. This process is called "pro rata."

What does this mean? Let's assume that 10% of a \$100mn venture capital firm that you invested in was put in Facebook in say 2005 in the first VC funded round, called the A round. That means \$10mn of the fund was invested in Facebook at a valuation of say \$1bn. The CFO of the VC firm called you and asked for \$10k from you for an investment in Facebook. Then in 2006 (1 year later) another venture capital firm invests in Facebook at a valuation of \$2bn. Since Facebook is a great company and since the VC firm that you invested in doesn't want their percent ownership of Facebook to be diluted, then they will call all of their investors and ask them to invest in Facebook again so that the amount they own of Facebook remains the same percent wise. This is called "pro rata". You contribute more money (or your "pro rata") to offset dilution. This is why VC firms typically only invest 80%-90% of your investment as they leave 10% to 20% left over in case there are "pro rata" investment follow-on opportunities.

We know that networking is the most important skill that we can learn in business. Venture capital firms get access to the best deals by networking aggressively. Your success in business will be predicated on the strength of your network, so make sure to connect with everyone you have ever met with using LinkedIn.

Venture firms love to invest in the same entrepreneurs over and over again (of course assuming the executives they are investing in have had a successful exit in the past). Venture firms also work with competing venture firms by introducing them to their portfolio companies so that other VC firms can lead future rounds. Co-opetition in the venture industry makes it incredibly unique compared to other roles in financial services industries. You usually

how do vc firms get deals?

- ✓ network network network
- ✓ past investments
- ✓ other vc introduce firms to vc
- ✓ "why am i so luck to see this..."
- ✓ universities (goog example)

need to fight to get access to the best investments in VC though. If you are introduced to a potential investment by another VC firm or from a friend, always ask yourself “why am I so lucky to be seeing this investment opportunity?” Unfortunately the reason can sometimes be that nobody else wants to invest. Venture capitalists also love to spend time walking up and down the halls of the best universities in search of the next Google!

Since venture capital firms often become “stuck holders” or long term shareholders in illiquid investments, they have to do an enormous amount of due diligence before deciding whether or not to invest in a company. Venture capital employees will leverage LinkedIn and find contacts of theirs (or their friends) that know the management team of a start-up they are considering investing in when doing background checks.

how vcs do due diligence

Venture firms will also study the competition at length and often interview them as well. I found from working in the hedge fund industry years ago that meeting with competitors and asking them what the weaknesses are of their competitors really helps you to find gaps in an underlying company’s business model (of course assuming that you are not compromising your integrity by discussing confidential information with those not privy to this information).

Venture firms will also analyze in great detail what the size is of a particular market they are considering investing in. Quite often they won’t invest in a company that has a T.A.M. or total addressable market of less than \$20bn. Why? Because they want the company they are investing in to get at least 5% market share of this market in the very long run, which equates to \$1bn+ in annual revenue. Venture firms have to aim high as many of their investments will lose money. Often all you need is a handful of investments in a given fund to make money for the fund to be incredibly profitable.

I know that the end markets or business models of many companies that VC firms invest in will change materially in the long run. As such, it is always prudent to invest in industry veterans that have been successful pivoting or changing their business models in the past.

Each venture capital round has a different venture capital firm leading the investment round. Investors in earlier rounds usually invest again as well so as not to get diluted (we covered this in the pro forma explanation). Most venture backed investor rounds have several different venture capital investors for risk management purposes. The same thing happens with IPOs and investment banks, which will cover

vc lead investor

&

deal composition

later in this book. Several investment firms working together is called an ‘investment syndicate’. Why does this happen? Because the investment rounds are enormous. Ask yourself “would I ever only get loans many years from now when my business is massive from just one bank?” Heck no! You need to diversify by doing business with several banks so they will compete for your business and give you the best terms.

So what is a good blueprint to use for a successful venture capital investment? Here is a model that works (for VC and other investments):

- 1) Make sure the management team is strong and with a deep bench (if it is a later stage investment). It is ok if the management team has failed in the past....but make sure they learned a lot from this failure and that they have had multiple successes (past exits) as well. Chances are if they have made other investors money in the past, then they will make you money as well (or at least have a higher probability of making you money). If the management team has no experience or if they are just out of school, make sure they have a solid board of advisors.
- 2) As mentioned earlier, you need to invest in companies that compete in markets with enormous TAMs as you want to get paid huge if they make it big!
- 3) If this is a later stage investment, it is more often than not prudent to make sure that the previous investors have great reputations for returning a very high return on investment to their investors over the years. The same can be said for an investment in anything!
- 4) Lastly (yes I know it’s bizarre that I list this one last....) we need to make sure that the company has an incredibly disruptive business model. Can they do to the industry that they participate in what Airbnb has done to the hotel sector? What is unique and proprietary about their value proposition? Is the market too crowded? Is it scalable (meaning can revenue growth massively accelerate with little additional investment capital and labor)?

I will keep saying this: ‘ideas are commodities, but execution is not’. Start always with a solid management team. If you aren’t thoroughly impressed by the management team’s ability to get you excited about their business prospects, then pass on this investment. Make sure that the founder(s) is not running the business to make money. Make sure that they are so incredibly driven that they want their company to literally change the world. Otherwise, this founder might look to sell the company at a very low return on investment. They need to convince you like you are a customer. They need to sincerely convince you that the reason that they were put on this earth was to make their company bigger and better than Apple, Inc.

Attitude is everything.

who do we back?

- ✓ strong management team (ok if they have failed before...)
- ✓ huge tam
- ✓ strong syndicate
- ✓ disruptive business model

preferred shares & harvest



There are many different legal structures for ownership of investment vehicles. We will only cover the most common ones and we will do so in easy to understand terms (my boss at hedge fund Citadel used to tell me that if I can't explain it, then I don't understand it)!

security structures:



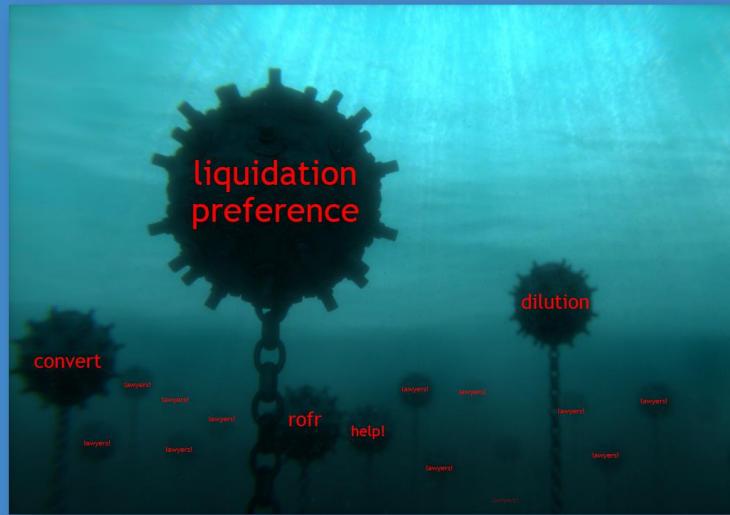
You are done if you don't lawyer up when starting a company! www.tiny.cc/chris49. As painful as it may seem, you need to hire a lawyer to help you with the legal paperwork of protecting you and your company and your company if you are accepting investments from anyone, including a venture capital firm. If it's costly, don't worry as you can bill this to your company. In fact, after you raise money from investors, you can bill your company for this. I

used to amortize my legal set up fees for my companies over 60 months (or 5 years), which is allowed under US corporate accounting laws.

You wouldn't operate on yourself if you needed surgery. Why? Because doctors spend 4-5+ years in medical school learnings how to not kill patients! The same can be said for lawyers, who spend 3+ years learning how to not kill your career, business and life. If you work for someone else, you need to hire a lawyer for \$500+ to quickly review the contract you are signing so you can protect your family and your assets. Your employer is likely cool but her or his lawyer is never looking in the best interests of your family.

Your employer did not write the legal employment documents; Rather, her or his lawyer did....so please lawyer up like Peter Parker did in that movie clip you just watched. ;)

not understanding security structures is a death wish.



common stock

- ✓ the lowest of the low
- ✓ the last claim on the company
- ✓ usually can be sold to others
- ✓ if firm buys then treasury shares

preferred shares

- ✓ senior claim to common shares
- ✓ liquidation preference
- ✓ get dividends before common
- ✓ vc firms get preferred
- ✓ employees get common

If a company goes belly up and there is a little bit of money left over then the first to get their money back are the banks or people that loaned the company money. The last class of investors to get paid back are the common stock holders. Employees of a firm that is VC backed usually get common stock. The VC investors usually get shares that are better, or preferred. Not surprisingly, they are called preferred shares.

Why would anyone want to own common stock then? Because they are very easy to buy and sell. Most stocks on the stock exchanges are common stock.

convertible preferred

- ✓ at IPO preferred shares convert to common shares
- ✓ when you buy stocks in US markets they are common shares
- ✓ sometimes convert = 2:1 ratio

Don't ever value your company too high when dealing with investors. I know that this sounds strange. If you raise multiple investment rounds, existing investors usually only agree to let you raise more money if it is done at a much higher valuation. Why? Because they want their shares to be worth more! If you raise more money at the same valuation as the previous investment round, then new investors have to be given new shares, which dilutes existing investors' ownership stake in the company. Keep valuations low enough so that you have the luxury of being able to raise more money at a higher valuation in the future. A "down round" can destroy a company as existing investors and current employees will be upset that their investment is now worth less!

down round?

- ✓ if you price the series a too high
- ✓ price of new shares (b) is lower
- ✓ everyone is angry at the ceo
- ✓ anti dilution clause protection

up round?

- ✓ if you price the series 'a' low enough (this is smart)
- ✓ series b is higher valuation
- ✓ vc from a round does 'pro rata'
- ✓ therefore no dilution

It is always prudent to price the company during the A Round low enough so that you can do the B Round at a higher valuation.

i don't get it. show me an example

- ✓ ok I will! assume you are sequoia
- ✓ you led the series 'a'
- ✓ you own 10% at a valuation of \$1m
- ✓ you own \$100k worth and 100k shrs

i don't get it. show me an example

- ✓ now kleiner does series b at a \$2mn valuation and new shares are created because employees and sequoia aren't selling their shares!
- ✓ so now you own <10%... you got diluted!
- ✓ why? because 500k shares were created for kp
- ✓ $\$2\text{mn}/1.5\text{m shares} = \$1.33/\text{sh.}$

i don't get it. show me an example

- ✓ i'm only a bit upset.. $100\text{k sh} * \$1.33 = 33\%$ return
- ✓ i now own 6.6%
- ✓ not fair....
- ✓ i should own 10% darn it!
- ✓ i have rights!

i don't get it. show me an example

- ✓ but wait as i have legal protections
- ✓ per the legal docs, 'pro rata'
- ✓ $10\% \text{ of } \$2\text{mn} = \200k
- ✓ if i buy ~50k more shares then no dilution for me
- ✓ solution.....kleiner only gets to buy 450k shares

sequoia owns preferred shares so they had the right to invest a pro rata amount of \$67k to offset dilution!

this is why vc firms only invest 75% - 90% of a fund.

'capital call'

convertible debt

- ✓ this is a debt instrument and hence has senior debt claims over preferred shareholders
- ✓ if the firm can't pay the debt, then the convertible debt holders take your stuff (cars, factory etc)

convertible debt

- ✓ government tax incentive not to pay debt on interest for start ups
- ✓ [side note on nol's startup tax benefit]
- ✓ in between a and b round many startups do a 20% discount convert

Series B in 6 months (which is 2 years after the Series A). The start-up can raise debt from an investor (or venture debt investor like Silicon Valley Bank – also called SVB). This debt can be at an annual interest rate of say 8% and will convert into shares (or equity) once the B round is done at a 20% discount to the Series B valuation.

Warrants can be granted to service providers like legal or debt firms that do business with a start-up. It is just another way to give financing flexibility to a start-up.

Options are granted to employees slowly over a long period of time. An option is the right to buy or receive shares in a company in the future at a certain price. They are slowly granted over time or else employees might quit after receiving them. They are given usually over 4 years so that 25% of the options realize their true value (or “vest”) every year for 4 years. After two years this employee in this hypothetical example is “50% vested” and then “100% vested over 4 years”. CEOs of publicly traded companies and many employees also receive stock options that “vest” over time. Vesting is also known as “golden handcuffs” for employees to make sure that they remain loyal and don’t leave for another company.

Sometimes start-ups plan on doing the B round, for example, about 2 years after the A round. However, in this hypothetical scenario, the start-up unexpectedly immediately runs out of money 1.5 years after the A round. As a result, the start-up needs to raise money right away. The start-up was planning on raising a large amount in 6 months anyway....but needs a small amount of capital to make sure they can make payroll before doing the

warrants

- ✓ a startup can incentivize investors when they invest by giving them warrants ('an option to get new shares later for free')
- ✓ options are shares that exist (from the options pool). by contrast, warrants are worth less than options as they are new shares.

options

- ✓ why do we grant options?
- ✓ call option = the right to buy shares at a specific price in the future

Questions Based on Chapter 4:

1: Who has the highest claim on a company?

- a) Common Shareholder
- b) Option Holder
- c) Preferred Shareholder
- d) Debt holder

2: VC firms prefer backing founders that they have successfully invested in in the past.

True or False

3: Investors in VC firms have the right to invest in future rounds and this is called their “pro rata” rights.

True or False

CHAPTER SUMMARY



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history of vc is important to understand. term sheets. security structures. ‘be greedy when others are fearful...& vv’ ‘you better lawyer up #%^@*&%\$’!



We covered a lot in this chapter. We even watched a clip from an awesome 1960s cold war movie called Planet of the Apes. Let's end this chapter with this... www.tiny.cc/chris48 ;)