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MuMaté (B-2): Confidential for Cantor

Jonathan Cantor looked over DPV's standard template for a Series A term sheet. He would have to fill in several items, including the amount of capital and shares to be offered, option pool size, and board composition. Otherwise, the template's boilerplate provisions were based on VC industry norms for a "founder-friendly" deal, so Cantor thought they should be acceptable to MuMaté management. Those provisions included:

- Convertible preferred stock with an 8% annual dividend, a 1x non-participating liquidation preference, and no redemption rights
- Voting rights for Series A as if converted to common
- Antidilution protection
- Pro rata right to participate in future financings
- Linear vesting of employee options over 48 months after a 12-month cliff
- Founder common shares vest 25% on closing, with the balance vesting linearly over 36 months. Unvested founder shares subject to buyback at fair market value
- Consent of a majority of preferred shares required for: dividends on common; preferred or common repurchase; loans to employees; merger or sale of substantially all assets; creation of a new security; incurring debt senior to Series A; change in principal business; investments in third parties; and major capital expenditures

This was the first term sheet that Cantor had presented for a deal that he had sourced personally since he joined DPV nine months ago. MuMaté was exactly the type of product that he had been hired to invest in: an innovative healthy-lifestyle brand, on the verge of exploding nationally. But Cantor knew that MuMaté still faced many risks, and that he personally had a lot at stake. His mentor at the firm, Ed Rodriguez, had told him: "The partners want you to take the lead in negotiating with MuMaté. There's just one constraint: you can't invest more than $3 million in this round. We like MuMaté a lot, and we think you may have partner potential, so that seems like a reasonable amount to spend on a test of your investing skill."

Professor Thomas R. Eisenmann and Research Associate Alex Godden prepared this case. The company mentioned in this case is fictional. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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Cantor had to decide how much capital to offer and how to value the company. According to MuMaté's projections, its cumulative capital requirement would peak at about $2.5 million. The cost side of MuMaté's projections seemed sound, but there was considerable uncertainty about whether the startup would sustain its momentum and meet its revenue projections. Over the next 18 months, MuMaté would have to fill inventory pipelines, invest in advertising, and staff up marketing and operations—all before knowing whether its brand was more than a West Coast fad. This "risk capital" would represent about half of the $2.5 million that MuMaté required. The second half could be viewed as "success capital." If MuMaté's business plan was successful through 2013, then any subsequent investments made during 2014 and beyond would be much less risky.

This "risk capital vs. success capital" distinction suggested that DPV could stage its investment. DPV might offer, say, $1.5 million for Series A, then follow with a Series B round *only* if the company turned out to be successful. But Cantor also had to consider whether this staged approach would yield an acceptable equity stake for DPV. DPV preferred to own a 20% to 30% stake in its portfolio companies when they were ready for exit or IPO—a smaller stake didn't really warrant a partner's time. Allowing for dilution from later rounds, that meant that DPV typically aimed for a 25% to 40% equity stake when it was the sole investor in Series A. Assuming a $1.5 million Series A investment, to stay within this 25% to 40% target range, the highest post-money valuation Cantor could offer would be $6 million. Would MuMaté management accept this? Or, did it make sense to relax the target range? After all, without raising any outside capital, MuMaté had reached a $3 million annualized revenue run rate based on its April 2012 results, and was on track to meet budgeted 2012 sales of $8 million. Not many firms in DPV's portfolio had achieved this level of financial performance prior to their Series A.

Cantor knew that with a staged approach, if MuMaté continued to be successful over the next 18 months, its Series B shares would be sold at a substantial premium to the Series A price—perhaps 2x. DPV could avoid paying this high Series B share price by providing, in a single initial round, 100% of the capital that MuMaté was likely to ever require. With this "one big round" approach, it probably made sense to add a modest buffer just in case growth was stronger or margins were lower than expected, which implied a $3 million Series A. But would MuMaté management find one big round appealing? They almost would certainly recognize that with a single, bigger round instead of two smaller, staged rounds, they would be trading greater equity dilution in an upside scenario in exchange for having reserve capital on hand in a downside scenario. With a staged approach, a startup that had to raise money after missing key milestones faced a down round and big dilution—if it could raise capital at all. The risk of a stumble was all too real: Ed Rodriguez had told Cantor that he guessed that MuMaté had a one-in-three or one-in-four chance of meeting its 2015 revenue projection, and that DPV's investment in the company might otherwise have little or no value.

Cantor did some back-of-the-envelope valuation calculations using an approach often employed by his colleagues at DPV and other venture capitalists. Consistent with its funds' past performance, DPV aspired to earn a pretax return of 25% across its entire portfolio. To do so, DPV's partners knew from experience that they needed each of their portfolio winners to deliver, on average, an exit multiple of at least 5x–10x in order to offset portfolio investments that "did just okay" or generated losses. Assuming a $3 million Series A investment, exiting at a 5x–10x multiple implied $15–$30 million in proceeds to DPV. MuMaté had projected revenue of $50 million in 2015. If they were acquired that year at a 1.4x revenue multiple, consistent with beverage industry transaction history, then total acquisition value would be $70 million. Assuming a single funding round and no subsequent dilution, exit proceeds to DPV of $15-30 million would require a Series A equity stake of 21.4% to 42.9%—which was within DPV's target range for its terminal equity stake. This in turn implied a Series A post-money valuation range of $7–$14 million.

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Cantor also employed an expected value approach to valuation that he had learned in his corporate M&A job at Nestle. Achieving a 25% return on a $3 million Series A investment required DPV to earn, on an expected value basis, exit proceeds in 2015 of $5.86 million. Applying the midpoint of Rodriguez's one-in-three or one-in-four estimate for success odds, the expected value of total proceeds from a 2015 MuMaté exit was $20.4 million ($70 million x 29.2%). $5.86 million represented 28.7% of this expected value of total proceeds. So, any valuation that gave DPV more than a 28.7% equity stake—or equivalently, any post-money valuation below $10.45 million—should meet DPV's hurdle rate. It gave him some comfort that this figure was close to the midpoint of the range derived using the first approach. But when he reflected on how many tenuous assumptions both calculations were based upon, Cantor cringed.

Cantor also wrestled with how to handle governance questions. He was concerned about keeping Maxwell as CEO over the long run. She had shown tenacity, drive and creativity in bringing MuMaté to this point, and Maxwell had impressed DPV's partners. However, she had only limited experience as a general manager, and taking MuMaté to the next level would require new skills. To protect its investment, DPV would need the flexibility to switch CEOs, if that became necessary. It seemed best to establish this expectation from the outset, but Cantor knew that it would make Maxwell uneasy and wondered how he could reassure her. Perhaps accelerating the vesting of founder common shares would help.

A related issue was whether to exclude Taylor from MuMaté's board. Cantor was sure that MuMaté's founders would object to this. Taylor was the product's inventor and she had great instincts about building the brand. But the board could get her input without making Taylor a director, and having a large, unwieldy board had many downsides. When it was the sole investor in a Series A round, DPV had a strong preference for three board members, comprised of the founder/CEO, one DPV partner, and an outsider recommended by management and acceptable to DPV. Bigger boards could slow down decision making, especially when even numbers of directors led to deadlocked votes. And relationships could get messy whenever a senior manager was subordinate to the CEO in the context of day-to-day management, but a peer on the company's board.

Cantor expected friction over other term sheet issues. For example, many first-time founders were uncomfortable with the idea that their equity should be subject to vesting, even though this was standard practice with venture capital rounds. Likewise, he expected to squabble over the size of the option pool that MuMaté would need to create before Series A was closed. Option pools for Series A firms ranged from 10% to 20% of post-round fully diluted shares; startups that planned to hire more managers needed a bigger pool. But what did this range imply for MuMaté?

As he entered figures into the term sheet template, Cantor wondered whether he faced competition from other investors for this deal. When he had asked Maxwell whether she was talking to other VCs, she had responded cryptically, "We are looking at a range of funding options."