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JEFFREY BUSSGANG

Raising Startup Capital

How do you finance a new venture?

This question must be answered by every creator or leader of a startup enterprise—whether it is for-profit or not-for-profit, in the public or private sector. Every new venture (even if it is a new undertaking within an established organization) requires money, yet every venture is different in its financing requirements. The amount may be modest or substantial. It may be needed in a lump sum or in a series of payments. And it can take a variety of forms from a wide variety of sources.

Financing is always on the mind of the founders of a new venture, even as they go about all the other tasks and activities involved in a startup, including developing the product or service or program, building an organization, and establishing relationships with partners and customers. Money is like oxygen, literally sine qua non—*without which there is nothing*. The questions thus keep coming: How much money do I really need? When must I have it? What is the best type of funding for me? What is the best source for it? How do I go about finding and securing it?

In this note, I will try to help you answer these questions by addressing the following topics:

- **Types of funding**. The two major types of startup capital are equity funding and debt funding although there are a few hybrid flavors as well.
- **Sources of funding.** These include venture capital firms, angel investors, crowd-funding, and accelerators/incubators.
- **What investors look for**. Each source has a different funding process and set of criteria which you need to understand before seeking funding from that source.
- **The mechanics of equity funding.** Seeking and securing funding involves setting amounts, agreeing to terms, and defining relationships.

For most entrepreneurs, the actual content of the enterprise—the mission, the product, the team—is their primary interest or first love, not the mechanics and process of financing. But funding for a startup is like oxygen—without it, you cannot survive long enough to build the team, assemble the team and fulfill your mission. Money, along with its related structures and strings, plays a major role in enabling you to accomplish your goals and realize your dreams.

Senior Lecturer Jeffrey Bussgang prepared this note as the basis for class discussion in *Launching Technology Ventures*. Bussgang is a general partner at Flybridge Capital Partners. Some of the source materials in this note are taken from his book, *Mastering the VC Game* (2010), published by Portfolio.

Types of Funding: Debt or Equity

There are two main types of financing for a new venture: debt and equity.

Debt Financing

Debt financing is exactly what it sounds like it is: the investor provides you with a certain amount of capital that you are obligated to repay. It is a loan. The interest rate varies from loan to loan, as does the term. The key feature of debt financing is that the amount you owe the investor is fixed—principal plus interest. You know exactly how much you owe and when it must be paid back. Many of us are familiar with loans, such as home mortgages or college loans, from our personal dealings and debt financing for start-ups have many similar elements.

Because the total possible return to the debt investor is similarly fixed—principal plus interest—the investor prefers to fund ventures that have stable cash flows, are not involved in risky or untried endeavors, or that have assets that can be collateralized. Debt investors prefer ventures in which some aspect—such as a product or service type, a technology, or a business model — is known and has proved to be successful, because they are at risk of losing part or all of their investment if the venture defaults or fails completely. And unlike the equity holder, the debt investor has no incentive to gamble on a risky approach in hopes of a higher return, because the upside is limited to the interest rate-based terms defined in the loan agreement.

Debt financing typically falls into one of two categories: cash flow financing or asset-based financing.

Cash Flow Debt Financing With cash flow financing, the venture repays principal and interest from cash received by the venture in the course of conducting business. There are no assets of sufficient value that could be collateralized to pay off the loan.

Banks and other types of financial institutions that offer cash flow financing usually require that the venture has had stable cash flow for some amount of time and that it has conservative, future expectations—as evidenced by committed orders or subscriptions or the like—that the required income will continue through the course of the loan. The lending institution may also seek to reduce its risk by placing various restrictions or requirements, known as covenants, on the loan and the enterprise. For example, the bank might require the venture to maintain a certain cash balance or set a minimum debt/equity ratio. If the covenants are not met, the institution would have the right to exact penalties, change the terms of the financing, or even call the loan and demand immediate repayment. "Tripping" covenants is dangerous as a company can be forced into bankruptcy if the loan is called. Typically, the debt holder doesn't care about customers, employees or equity holders. All they care about is getting their loan capital back.

Non Cash Flow-Based Debt Financing[1] For enterprises that do not have a history of a reliable cash flow, asset-based financing is another available form of debt lending. The venture gives the lending institution a lien—that is, the right to the possession of some property or asset if the debt is not repaid. There are many forms of assets, including accounts receivable, intellectual property, inventory of products or materials, equipment, or real estate. (A mortgage is an asset-based loan secured by real estate.) If the enterprise defaults, the lender can claim the asset, then hold it or sell it.

Other forms of asset-based loans do not directly involve tangible assets. These include the personally secured loan, which means that an individual with substantial personal assets agrees to guarantee the amount of the loan; letter-of-credit financing, which is an assurance from one financial institution—with which the venture has a credit relationship—to another financial institution that operates in a geography where the venture does not have any financing relationships; and government secured loans, which are financing arrangements backed by a government agency such as the Small Business Administration and others.[2]

One type of loan that does not directly involve tangible assets is "venture debt". This specialized type of debt is typically available to a company that has already received venture capital equity financing or coincident with an equity financing. Venture debt provides incremental financing, in the form of debt, from a firm that specializes in lending to technology-backed start-ups (e.g., City National Bank, Comerica, Eastward Capital, Silicon Valley Bank, Square 1 Bank). Because these are risky loans, the lending firms rely on the venture capital firms to help them identify and conduct due diligence to select the most promising start-ups. The venture debt lenders usually seek to improve their returns by requiring some amount of equity from the firms they lend to, often in the form of warrants, as part of the loan. This arrangement provides a young company—that likely would not be able to raise further debt financing from traditional lenders—extra financial runway (beyond the original equity financing), at a lower price (i.e., a lower cost of capital) than would additional equity financing. If they could get it, that is. Although popular with high-growth firms that are backed by top venture capitalists, venture debt is a relatively rare form of financing. One industry analyst estimated that only 350 companies received venture debt financing in 2012.[3] There is a downside to venture debt – you eventually have to pay it back, and typically a startup is faced with making debt payments before they are cash flow positive. This dynamic means, in effect, that the startup needs to raise additional equity capital at a later date (ideally at a higher price) to help pay back the venture debt.

Equity Financing

Equity financing is a very different animal from debt financing. The equity investor provides an amount of capital to the enterprise in exchange for a specified share of ownership. Unlike the debt investor, who has no claim on the enterprise beyond the amount of the loan, the equity investor shares in the venture's upside value creation—and can also take a hit from its losses. And, unlike the debt investor whose return is fixed, there is theoretically no upper limit on the return the equity investor can reap.

Because the potential for a large return exists, the equity investor is typically willing to invest in riskier ventures—those developing breakthrough products, working with emerging technologies, or operating with unproved but potentially transformative business models. Because equity investors take a large risk with their investment, they also demand a much higher return on their capital when things go well—typically targeting in the range of 30-60 percent as compared to the 10-15 percent rate that is common in debt financing. Put another way, an equity investor is looking to generate a 5-10x return on their capital. I will cover the economics of equity financing and the different sources of equity financing in more detail later on in this note.

Equity investors also behave very differently from the financial institution that offers debt financing. The equity investor is typically a professionally-managed firm whose sole business is to invest in new ventures, using funds developed from a number of limited partners such as pension funds, endowments, and wealthy individuals.

The equity investor is much more involved in the management and operations of the funded venture. Depending on the deal structure, the investor may occupy one or more seats on the board of directors, will expect to have a voice in key decisions, and will closely monitor the performance of the venture—sometimes on a week-to-week basis.

Convertible Debt

There is another form of financing, called convertible debt, which combines features of debt financing and equity financing. It may also be called a convertible bond, loan, note, or debenture. [4]

The distinguishing feature of this type of financing is contained in the word "convertible." The financing starts out as debt financing, but the investor expects to convert the debt into an equity share at some point in the life of the venture. This type of financing typically comes into play at the earliest stages, when the proposed venture has no assets and little or no cash flow—so is not an attractive investment for either cash-flow or asset-based debt financing—but does have a large potential upside.

There are features of convertible debt that may make it more attractive to the entrepreneur than equity funding. For one, the transaction costs (measured in both time and dollars) incurred to arrange for convertible debt are lower than those involved in closing an equity financing. A typical convertible debt financing may cost only $5,000-10,000 in legal fees whereas an equity financing might cost more like $20,000-40,000. Also, there is the issue of dilution. If the entrepreneur puts off setting a share price until a later date, when presumably the venture will be worth much more than at the time of the convertible debt financing, her shares will suffer less dilution.

Why would investors make such a loan? They may be convinced that the prospects for the venture are so hot they do not want to risk being left out of the deal. Further, they get a debt instrument (with all the downside protections) that they can convert into an equity instrument (with all the upside opportunities). Convertible debt investors will often include economic provisions in the loan, usually in the form of a share discount—often in the range of 15-25%—when the share price is finally set in the next round of financing. They may also negotiate a ceiling or cap price for the valuation of the conversion, thereby reducing the risk to the investor that the equity conversion price for their note will be overly high. For example, a typical convertible debt deal for a new venture might be a $1 million note with a 20% conversion discount and a pre-money cap of $5 million. In this case, if the next round of financing were set at, say, a $10 million pre-money valuation, the $1 million investment would still convert at a pre-money valuation of $5 million. If the next round of financing were set at, say, a $5 million pre-money valuation, then the $1 million investment would convert at a 20% discount, or the equivalent of a $4 million pre-money valuation.

Convertible debt is a favored form of financing for friends and family deals at the very outset of company creation. It enables the investors, usually non-professionals, to help the entrepreneur in the early stages without having to go to all the complication of setting a share price (leave that to the professionals), but also ensures they get a piece of the action if all goes well.

Convertible debt can also make sense shortly after the company is founded but before taking on equity investment for the reason already mentioned: when an entrepreneur does not want to get involved with the cost and complications of an equity deal. In recent years, professional venture capital firms and seed funds have used convertible debt deals as their standard framework for early-stage ventures, frequently with a price cap.[5] Naturally, it is more favorable to the entrepreneur to not have a price cap.

How Much Money Should I Raise?

Key questions in considering financing options are how much money you think you need, how much money you think you want, and how much money you can raise. It would seem that more money is always better, but that is not necessarily the case. There are trade-offs to consider.

The key issue you have to contend with is the cost of capital and the structural conditions that the capital imposes on you. When raising equity capital, the more capital you accept, the less your share of the enterprise is worth—your shares are diluted. Yet having plenty of capital gives you more leeway to make mistakes or manage through downturns or unexpected setbacks. Jack Dorsey, founder of Twitter, recalls that venture capitalist Marc Andreessen had advised him to take as much money as he could, as early as he could, so he could build a "war chest" that would enable him to "weather the storm."[6] That particular storm was the economic downturn of 2008-09, but there will always be storms in the early life of a venture that need to be weathered, and ample capital can always help.

A major benefit of raising *less* money and operating in a more capital-efficient manner is that your share of the venture is less diluted. Having taken less capital also expands your options when it comes to the sale of the business or your exit from it. Suppose a venture, before receiving any financing, is valued at $10 million. The venture then raises $5 million from an equity investor, which brings it to a $15 million "post-money" valuation. The equity investor will typically be satisfied if the venture can be sold for $75 million or more, a price that represents a five-fold return on invested capital. However, if the same company raises $15 million on its $10 million valuation, the post-money valuation is $25 million. The equity investor will now be looking for a sale above $125 million to realize that fivefold gain.

In situations like this, there is the possibility that the goals of the investor and the entrepreneur will be misaligned. You, the entrepreneur, might be delighted with a $75 million exit opportunity. If your stake in the venture is 20 percent, that exit would fetch you $15 million—a life-changing event. But the equity investor, particularly a venture capitalist with a large fund, may not be willing to settle for anything less than the $125 million and may try to block the transaction in order to play for a bigger win. This is largely because equity investors typically have a portfolio of investments and have many opportunities to generate return. They are more focused on the overall return of the portfolio and are incented to take additional risk to yield a higher return on each of their investments. You, however, have poured heart and soul, resources and capital, into your one venture and may feel that the $75 million outcome is your best wealth creation opportunity. You may not want to take the risk that another, better opportunity may eventually come along. Putting the business into good hands and exiting with life-changing wealth may be more than enough for you. That is the downside of taking too much money—the more money you raise, the more pressure there is to generate a large return.

To help reframe the "how much should I raise?" question, some entrepreneurs like to think about their startup as an experimentation machine. This philosophy, popularized by Eric Ries in *The Lean Start-Up*, suggests being precise about the hypotheses you are testing at any given point in time, the type of experiments you require to test those hypotheses, and then raising only as much money as you need to fund those experiments. Many investors believe these experimentation cycles should be as short as 12-18 months and like to see companies funded only for this period at a time before committing additional follow-on capital.[7]

The Syndicate When securing financing, many entrepreneurs build an investment *syndicate*, which means that the entrepreneur takes capital from two or more investors. The benefit of a syndicate is that the entrepreneur can take advantage of the expertise of the members of the investor firms — in such areas as recruiting, strategy, and business development—and will have access to two (or more) sets of deep pockets for future financing rounds. The entrepreneur may also be seeking to reduce the risk that any one investor will take too dominant a role on the board or have too powerful a voice in decision-making. This dynamic is particularly important in the follow-on financing. Having two firms means that if one drops out, for whatever reason, the other firm has the opportunity to step up and help lead the next round of financing. Another reason to have two firms—assuming they don't collude—is that it creates a competitive dynamic that may help yield a better price in the next round.

But forming a syndicate has complications and downsides. Not all investors are open to joining a syndicate—many have an explicit policy prohibiting such participation. Other investors will join a syndicate, but only if they have control over the process of identifying and choosing co-investors. Still others have an elitist view to syndicate formation—if it is a "top tier" firm, then they are welcomed in. If it is a less well-respected firm, then they may get pushed out. Finally, syndicates often increase the entrepreneur's dilution, because the aggregate of the syndicate's invested capital will usually be higher than the amount invested by any single firm. For example, many venture capital firms will insist on obtaining at least 20 percent ownership and are often keen to secure as high as 30 percent. Thus, if you take investment from two syndicate partners, you may have to sell at least 40 percent of your company to them.

In the end, the entrepreneur needs to raise the right amount of capital for their venture, under terms they can live with, from an equity investor they believe they can work with effectively. The journey to build a business and create value is a long and arduous one and having a strong, aligned investor as a partner is critical.

Stages of Investment

The decisions about the amount of money to be raised, and the best source of funding for your venture, depend to some degree on what stage of the business you are in. The stages of a new venture are typically defined as follows:

- **Seed.** The earliest stage of a venture in which the founding team is just getting things off the ground. You, as entrepreneur, have an idea which you have expressed in a presentation or perhaps a prototype in the hands of a few customers. You may have gathered a little feedback from potential customers, but not much. The venture has no revenue. A typical seed financing might be as little as $500,000 or as much as $2 million.

- **Series A.** You have expanded the team. You have a beta or version 1.0 of the product, service, or technology. You have gathered lots of customer feedback, but the venture is still "pre-revenue" or very early in revenue development and has not yet achieved "product-market fit." A typical Series A financing might be $3-10 million although, in some instances where the company has accelerated very quickly after the seed, it can be more. The transition from seed financing to Series A is one of the most difficult ones for new ventures. One analysis suggested the mean success rate to raise a Series A after a seed is 27% whereas to raise a Series B after a Series A, the mean success rate is 35%.[8] These figures have declined over time as the number of small startups seeking funding appears to have increased while the total amount of capital available to startups has declined or remained flat.

- **Series B.** The enterprise is fully operational, with a full team in place and version 2.0 of your offering. You have achieved your initial product-market fit and are in the early stages of building a repeatable sales and marketing model. You are taking in solid revenue, typically in the $1 million to $10 million range, and growing fast (50-100% or more). A typical Series B financing might be $10-25 million although, again, larger amounts can be raised in special situations.

- **Series C.** You have the full team, a mature product, a well-defined and successful product-market fit and a repeatable sales and marketing process. You have revenue of greater than $10 million and the venture is profitable or nearly profitable. A typical Series C financing might be $20-40 million.

The below chart summarizes which types of funding are available at which stages of the enterprise:

	Funding Type			
Stage	**Convertible Note**	**Priced Equity**	**Non Cash-Flow Debt**	**Cash Flow Debt**
Seed	☑	☑		
Series A		☑	☑	
Series B		☑	☑	
Series C		☑	☑	☑

Sources of Funding

In this section, I will focus on four of the most important venture funding sources today: the venture capital firm, crowdfunding, angels, and accelerators. There are other funding methods that I will not cover here—such as self-funding from accumulated cash, personal lines of credit or trade credit lines, and loans from family and friends—because they tend to be used for small ventures whose goals are to provide the entrepreneur with a lifetime income but not to grow a substantial enterprise and create significant value. Nor do those forms of funding require specialized knowledge.

The Venture Capital (VC) Firm

The venture capital industry is small, exclusive, and like a club in nature.

The entire worldwide VC industry consists of fewer than seven thousand people working in less than one thousand firms, according to the National Venture Capital Association (NVCA). Not all of those firms, however, are making new investments every year—that is, only 500 firms are actively investing in new ventures. What's more, of the seven thousand investment professionals working in these firms, only a thousand of them can be classified as decision-makers who make investments and sit on the boards of directors of the companies they invest in.

These investors have a lot in common. One of the factors that ties members of the VC club to each other is that a large number of them emerge from a small number of schools: the undergraduate colleges and business schools of Harvard and Stanford universities, as well as a handful of other Ivy League schools and MIT. Over 95 percent of the major players are men.[9] Because VCs often join investment syndicates, there are frequently many overlapping relationships that have resulted from being co-investors and board members together in various start-ups. Venture capitalists also tend to have some common personal characteristics. They are intelligent, curious, omnivorous, driven to success, competitive, and often a bit geeky.

The firms in the industry are highly concentrated geographically. Silicon Valley and San Francisco, home to many of the world's leading technology companies, form the epicenter of the VC world. The Greater Boston Area is another strong nexus of activity, largely because Harvard and MIT are located there, with both universities providing strong training grounds for entrepreneurial and finance talent. Venture capital firms tend to locate where the talent is. For that reason, New York City is also an important center of VC activity, particularly in the areas of e-commerce, advertising and financial services.

The capital is similarly concentrated. According to the NVCA, approximately $94 billion of the $200 billion of total VC capital under management resides in California. Thirty-four billion dollars is managed in Massachusetts and $21 billion in New York. Those three states alone represent 75 percent of all capital under VC management. Throw in Connecticut, nestled between New York and Massachusetts, at $8 billion, and you have accounted for nearly 80 percent of all US investment capital — concentrated in just three geographic domains.[10]

So it is these 1,000 investors, hailing from a handful of institutions, operating in this tiny industry, located in three major geographical areas, that make decisions to fund VC firms that account for more than 20 percent of the gross domestic product of the United States and, in addition, provide medical care for one in three Americans.[11]

Particular Deals, Particular Fit The venture capital firm does what no other funding source can: provide capital to high-risk ventures that have uncertain outcomes and long pay-out periods.

Some six hundred thousand companies are started every year in the United States and the vast majority of them do not receive funding from venture capital. They follow the funding routes I have already described—self-funding, cash-flow financing, or asset-based financing—or angel investing and crowdfunding—which I will describe later in this notes.

The start-up capital required to start many businesses is relatively small—a few hundred thousand dollars up to one or two million dollars. These ventures usually have a reasonably clear path to success and can generate income within a year or two. The entrepreneur may tinker with their idea, hire an employee or two, and dribble in money as needed, working out of their basement or garage or in a corner of somebody else's office. An individual investor might be able to invest enough money for such a venture, thanks to a "liquidity event"—such as selling a previous company, receiving an inheritance, or getting a large payout from a stock holding or golden parachute. But very few entrepreneurs have the kind of capital—usually many millions of dollars, often tens of millions—that is needed to start and build a breakthrough venture over three to five or even ten years.

As a result, it is a very particular kind of entrepreneurial enterprise that venture capitalists fund. Usually it involves an idea with breakthrough, game-changing potential that needs large amounts of capital to get off the ground. The venture is typically technology-based and requires high-priced talent to develop the product or service and bring it to market. ("High-price" may mean the person is awarded a rich stock package in addition to substantial cash compensation.) The venture many not generate any revenue for several years, if ever. The entrepreneur who is a good fit for VC capital is the one who wants and needs the active participation of the capital provider in the oversight of the business.

The Structure of the Venture Capital Firm A venture capital firm tends to be organized (often without deliberate intention) around the thesis of James Surowiecki's book *The Wisdom of Crowds*—that is, no one person can be as smart as a group of informed, independent-minded people. These firms believe that the way to make the best investment decisions is to follow a democratic process rather than work within a hierarchical structure. Thus, VC firms typically gather a group of experienced investment professionals with diverse backgrounds and perspectives and do not allow any one individual's power or status to dominate the discussion. Robust group conversations and debates will ultimately yield better investment decisions than any one, smart individual might alone achieve. As a result, unlike most corporate environments, there's often no obvious power relationship between the professionals around the conference table, as VC firms typically collect smart people with strong opinions and then let them speak their mind, regardless of seniority or stature.

Given that essential characteristic, VC firms organize themselves in different ways. Some are built like classic consulting firms with a pyramid structure where large staffs of more junior professionals surround and support a smaller number of senior partners. For example, Boston-based Bain Capital Ventures (a division of private equity firm Bain Capital) has nearly forty investment professionals, of whom ten are general partners (also called managing directors) and the others are either associates, principals, or venture partners working their way up through the organization. At the other end of the spectrum, New York City and Boston-based Flybridge Capital Partners has four general partners and two non-partner investment professionals. Many small firms have an inverted pyramid structure, with only one or two junior professionals and a small, tightly-knit group of partners.

The Players Within the Firm However the firm is structured, there are precise and distinct roles in the venture capital world. These roles include: general partners, principals, associates, entrepreneurs in residence, and limited partners.

General partners (sometimes called managing directors or, simply, partners) are the most senior investment professionals in the firm. They decide which start-ups to invest in and sit on the boards of the companies once they are funded. They are often the owners of the firm, although a managing general partner title may be used to distinguish between the general partners who truly manage the firm from those who simply lead certain investments.

Some firms are federations of general partners, each of whom operates quite independently as if they were the heads of different disciplines in a law firm or specialties in a medical practice. In other firms, the general partners work closely together and make their investment decisions collaboratively.

A general partner typically has ten to twenty years of experience as a venture capitalist, as an entrepreneur, as an operating executive at a larger company, or perhaps even as a combination of the three. Many have an MBA or advanced technical degree in relevant fields, such as computer science, electrical engineering, or biochemistry.

Principals are general-partners-in-training and, as a result, eager to prove themselves to be worthy of promotion. They usually support the general partners in seeking out investment opportunities and in conducting the due diligence needed for them to make investment decisions. They provide input into investment decisions and, in some cases, may have authority to recommend investment opportunities subject to approval by the general partners. Principals usually have three to six years of work experience post-MBA, or other graduate degree, and are younger versions of the general partners—in character and ambition.

Associates support the general partners and principals and have no authority to make investment decisions themselves, but are an important part of the investment decision process as they often conduct much of the due diligence and make recommendations to the general partners regarding investing more time with particular companies and entrepreneurs. Some of them have recently graduated from a leading MBA program, most typically from Harvard, Stanford, or the Wharton School of the University of Pennsylvania. Others have an undergraduate degree only, usually in a technical field of study, and have been out of college for two to four years. Associates will often have worked for a few years in a start-up, a large technology company, or perhaps received some business training at a management consulting firm or an investment bank.

For all levels of investment professionals, the more years of experience they have the better. "The venture capital business is fundamentally an apprenticeship business," noted Terry McGuire, co-founder and general partner of Boston-based Polaris Venture Partners. "There's no school for it. Every truly successful venture capitalist has been mentored in turn by another successful venture capitalist over a long period of time."

There is debate among entrepreneurs and industry observers over what kind of background makes for the best venture capitalist. The venture capitalist who has been an entrepreneur can empathize with the management team and also bring useful operating skills to the table. On the other hand, professional venture capitalists know their boundaries (that is, they are less likely to interfere with management's purview) and tend to have broader networks and more sophisticated experience with various financing strategies and acquisitions.

Making the switch from entrepreneur to venture capitalist can be tricky. Ted Dintersmith of Charles River Ventures observes, "Venture capitalists don't run these companies. You invest in great people to run these companies. If you think they work for you like divisional presidents, you have it all wrong. In truth, you want to invest in people who are better than you, and make sure you work for them. The entrepreneur is your boss and customer combined."

The Limited Partner There is one more important player in the venture capital world: the limited partner or LP. The LP is important because he, she, or it is the source of the VC's money. Every three to four years, when the venture capital firm is raising a new fund, the partners travel around the country (and sometimes the world) catching up with their LPs, presenting the performance of their portfolio, updating them on any strategy or personnel changes, and then asking them again to invest their money in this risky asset class.

There are numerous types of limited partners, including:

- **Endowments,** e.g., universities such as Harvard, Yale, or Stanford
- **Public Pension Funds,** e.g., state pension funds, such as the California pension fund, CALPERS
- **Corporate Pension Funds,** e.g., IBM's pension fund
- **Sovereign Wealth Funds**, e.g., the government of Singapore's investment arm
- **Wealthy Families,** e.g., the Rockefeller family's investment fund
- **Funds of Funds,** e.g., special-purpose funds that are created to provide smaller institutions and families the scale to get into top-tier firms—such as Knightsbridge Advisers and FLAG Ventures

VC returns have a tremendous amount of dispersion, with the top managers generating far greater returns than the bottom. For example, a Cambridge Associates study showed that the top quartile of venture capital funds from 2002 and 2003 generated returns of over 8% IRR whereas lower quartile funds from those vintage years lost 4%.[12] In other words, an LP who is able to invest in one of the top VCs will make much more money, on a relative scale, than if they invest in a mediocre VC. Only a few VCs and LPs seem to get the formula consistently right.

An important subtlety to understand is that because VCs have investors in the form of LPs, there is an inherent conflict in their role as board members of your venture. The VC has two loyalties that may occasionally conflict: a fiduciary duty to generate the maximum return for their LPs, and a fiduciary duty to protect the interests of all shareholders in the companies they're investors in, and for which they serve on the boards. When these interests diverge, tension emerges between the VC and the management team that can lead to conflict and drama. Avoiding this natural tension is why many refer to the VC-entrepreneur relationship as a trust-based relationship. Taking the time to develop a strong relationship with your VC, where conflicts are discussed openly and honestly, is essential.

The Question of Size: Large Bets Require Large Funds Does the size of the VC's fund matter to the entrepreneur? Is bigger better? Yes, size does matter, but not necessarily in the way you might think. The VC's fund size matters because it is an indicator that the VC's goals are aligned with the entrepreneur's.

A bit of history illuminates this point. Silicon Valley–based Kleiner Perkins, one of the most successful VC firms in history, had a consistency to their fund sizes in the 1980s and early 1990s. In 1982, they raised a $150 million fund (their third) and in 1986 another $150 million. In 1989, you guessed it, another $150 million. And then in 1992, $173 million. Another modest increase, to $225 million, occurred in 1994.

Then something odd happened. Beginning in the late 1990s, the Kleiner fund sizes increased markedly, and in 2000 they raised a $625 million fund. Other firms were even more aggressive during that five-year period. With the rush to raise bigger and bigger funds in the midst of the bubble, there was even a moment when VC partnerships argued with their limited partners that they needed to have a $1 billion fund in order to stay competitive as a top-tier firm.

What caused this fund size inflation? In short, the Internet-fueled NASDAQ bubble. From 1996 to 1999, VCs began to see exit valuations with multibillion-dollar potential, not just hundreds of millions of dollars of potential. And so rather than deploy $100 million to $200 million over three or four years into start-ups at a clip of $5 to $10 million at a time, they tried to invest $1 to $2 billion over the same period by forcing $25 to $50 million at a time into their companies. And we all know how that movie ended: badly, in the bursting of the technology bubble in 2000-2001.

After the bubble burst, things have changed. Or have they? After all, the more capital under management VCs have, the more money they make in fees (like hedge funds and private equity firms, VCs typically earn "two and twenty" – 2% points of capital under management per year in fees and 20% carried interest).[13] So, the natural incentive for many is to keep fund sizes large, and therefore fees large, even if the fundamentals of the venture do not support it.

Kleiner Perkins ("Kleiner") cut their post-bubble fund, raised in 2004, to $400 million—smaller than their 2000 fund, but still nearly three times the amount they raised in their first few decades as a firm. And then in 2008 the fund was back up to $650 million. Perhaps they believe the 2012–2016 exit potential for today's start-ups is three times what it was in the early to mid-1990s. The extra fee income undoubtedly helps give them extra room to support rock star advisers like Al Gore and Colin Powell, who in turn help their portfolio companies make valuable connections at the top of important business and government organizations.

To be fair, this pattern has played out throughout the industry, not just at Kleiner. And, of course, anyone would have been thrilled to have been an investor in a fund (like Kleiner) that invested in Google, no matter how large it was. The point is that many funds have gotten very large, perhaps altering their strategy and the kinds of deals that are in their "sweet spot."

The key is to find a firm that is a good fit with your capital needs. If a VC forces too much money on you, it can have negative effects, including more ownership dilution and a higher valuation bar required to make your VC happy. On the other hand, if your investor does not have sufficiently deep pockets, you run the risk of getting caught short just at the moment when extra capital might be needed to get to the next level. Thus, the Goldilocks Rule applies to VCs and fund size: not too big, and not too small, but just right for your company and its capital requirements.

To find the right fit, you have to understand how much capital a VC firm wants to invest in its ventures. Whatever the firm's marketing materials may claim (I once heard a VC claim his firm would do deals from $50,000 to $50 million), the reality is that every firm has a sweet spot and if you as an entrepreneur are in it, you're better off than if you're not. The nature of that sweet spot comes down to the size of the VC's current fund, not their total capital under management. An entrepreneur should always ask about this when approaching VC firms.

The size of a VC fund influences the strategy and focus of the firm. Yes, big funds are interested in bigger deals, but there are some rules of thumb that can help you translate the size of the VC fund to better understand the size and kinds of deals the firm is most likely to do.

For example, if you're an entrepreneur with a start-up idea looking to raise around $3 million, then a VC firm with roughly $50 million in capital per general partner *in the current fund* is the right fit for you, but a firm with $100 million per partner would be too large. It might fund you, but you'd probably be considered a "training wheels" investment for a freshly-minted VC with an MBA on which the ink has yet to dry, rather than a serious investment for a senior general partner. If you're seeking $20 million, however, the $100 million-per-partner firm would be a good fit.

Something like $40-$50 million per general partner in the current fund is typical for an early-stage VC firm of four to five partners. Each partner would be expected to lead an investment in four to six companies over the three-year life of a fund, with $8 million to $12 million allocated per company, with at least half of the investment amount reserved for future rounds of financing. The initial investment would be in the range of $2 million to $8 million, with $5 million to $10 million reserved for follow-on financings. VC firms typically aim to own 15-20% of their portfolio companies.

Later-stage VC firms prefer more capital under management, as much as $100 million per partner, and they look to deploy $10 million to $20 million per company. Such firms prefer to invest in later-stage rounds of investments, after the venture has built its revenue and has established a more mature business model. Baltimore-based JMI Equity, for example, is a well-regarded later-stage investment firm with a fund of $875 million deployed by six general partners, or about $150 million per partner.

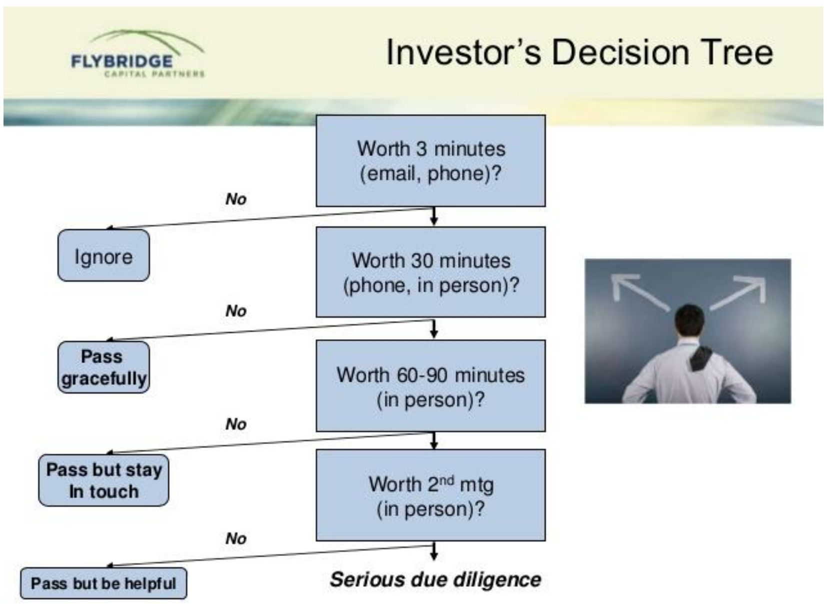
The size of a VC fund really does matter. And, as an entrepreneur, you want to do all you can to find that "just right" fit.

What VC Investors Look For in a Deal What does the venture capital firm want? What are the individual and the firm looking for when they consider making an investment in a new venture?

The process by which venture capitalists consider deals is known as the "deal flow" and it is a complex process to get right (See **Figure 1**). The venture capitalist wants to get a look at every interesting start-up, particularly those led by proven entrepreneurs. That's simply because the more deals a venture capitalist sees, the more likely he will have the opportunity to select a high-quality deal in which to invest. And by having a high-volume, high-quality deal flow, venture capitalists become smarter investors—learning something from every deal they consider and becoming more adept at detecting useful patterns.

The problem is that the volume of possible deals is so great—as many as three hundred to five hundred proposed deals per year—that no partner can review all the business plans that come along, let alone fund all the companies that might be worthy. The active venture capitalist—the one who will join the board of the company in which they invest—typically has the capacity to do just one or two deals a year and often have a year go by without doing a single deal if they are consumed with working with their portfolio. Passive venture capitalists—those who come in at a later stage, take a smaller ownership stake, and don't join the board—have greater deal capacity, but still only do three or four deals annually per partner.

Figure 1 Investor Decision Tree



Source: Flybridge Capital Partners, Used with Permission.

So, the volume of proposals is great and the number that gets funded is small. How can you improve your chances of being one of the chosen few? You need to do four things:

- **Hit the sweet spot.** Gail Goodman is president, CEO, and chairman of the email marketing firm Constant Contact. Gail estimates that she was rejected by more than forty VCs before securing her first round of VC money and by over sixty before securing her second. Although there was some overlap between the two rounds, this means nearly one hundred VCs were wrong to turn her down—the company currently has a market capitalization of over $600 million. "The biggest lesson I learned," Gail said, "is to get better and better at knowing whether you're in the VC sweet spot. For example, if all they do is enterprise software, and you're not in enterprise software, don't be there. Don't waste your time." In other words, find the right firm as well as the right person at the firm and, as in a general sales process, qualify that they are a fit for what you are doing.

- **Get the right people on the team.** You need to be the right person, and have the right team, to pursue this compelling vision and execute so as to bring it to life. Ideas are a dime a dozen. Having a world-class team that can uniquely execute on the ideas is golden. Every venture capitalist asks herself, "What happens if a 'fast follower' comes up with the same idea, raises more money, and recruits a better team?" The entrepreneur who has a clear, unassailable competitive advantage—an "unfair advantage"—is the most compelling entrepreneur when it comes to the pitch, and the team may very well make the difference.

- **Have a compelling vision.** You need a vision, an idea, an approach that gets the venture capitalist excited. Reid Hoffman's idea about how the Internet might be harnessed to bring professional people together caught the imagination of several venture capitalists. LinkedIn was an idea about how the Internet could change people's lives, Reid Hoffman said. The more dramatic and unrealized the vision, however, the more the experience and expertise of the entrepreneur come under scrutiny by the venture capitalist. That's why people are perhaps the most important attribute required in order to attract VC money.

- **Demonstrate momentum.** Venture capitalists like to invest in movies, not still photos. In other words, they like to see how a story evolves over time so that they can extrapolate what will happen over the next few years. If you can show momentum in your business—across any metrics or strategic objectives—you can build momentum in the investment process. If the story gets better with time, you pique VC interest and give the impression of being a "hot" company and therefore a "hot" deal.

So, venture capitalists are looking to back entrepreneurial teams that can effectively execute on the big vision and make it a reality. As Fred Wilson of Union Square puts it, "We venture capitalists love to invest in the serial entrepreneur who's done it before, knows the playbook, and won't make any of the rookie mistakes. And when those people come back, if they still have the fire in their belly to do it again, we're likely to say 'yes' almost every single time."[14]

But experience cuts both ways. An entrepreneur who knows physics doesn't believe he can defy gravity. Many venture capitalists prefer young founders who are incredibly brilliant and gifted even though they are inexperienced and naïve. Look at the case studies of the successful start-ups begun by college dropouts, such as Microsoft (Bill Gates), Dell (Michael Dell), and Facebook (Mark Zuckerberg). Fred Wilson's observation on Facebook is that the singular focus of the young entrepreneur is very powerful. "You have this twenty-five-year-old founder, Mark Zuckerberg, who doesn't have a wife, doesn't have kids, doesn't have anything in his life that's distracting him from what he's trying to do. And there's nobody saying to him, 'God damn it, take the money off the table. It's fifteen billion dollars. You should sell it now.' Instead, he's going for a hundred billion! Now that may be a stupid move or it might be a brilliant move. Only time will tell."[15]

The combination of these three forces—finding the right VC match, having a compelling vision, and assembling a uniquely strong team—is very powerful and attractive to the venture capital firm.

Without question, the odds are stacked against the entrepreneur. It can seem hard to get access to a member of the VC club and convince its members that your story is a compelling one and that you have the right team to execute against it. But with good preparation and thoughtful planning, a warm introduction, and a set of well-defined experiments and milestones, you can improve your odds considerably.

Once you have secured the interest of the VC, the next issue you need to face is the deal itself. But before getting into the mechanics of deal-making, let's briefly review the three other sources of venture funding.

Crowdfunding

Broadly speaking, crowdfunding refers to the activity of many individuals collectively pooling their resources to invest in private companies and projects, and it refers to several types of funding relationships that are similar in nature.[16] AngelList, Kickstarter and Indiegogo are a few of the best-known platforms for crowdfunding.

With crowdfunding, a large number of individuals (who are generally not investment professionals) can invest small amounts of their personal capital in a business, thereby distributing and limiting financial risk, and the business benefits from the capital it receives as well as the community it builds through the process.[17]

By providing a way for early stage companies to access small amounts of initial capital (amounts that would be too small for many angels or VCs to seriously consider), crowdfunding has helped fill a gap in the financing ecosystem.

There are three main categories of crowdfunding, regulated by the Jumpstart Our Business Startups (JOBS) Act of 2012.[18]

- **Token Crowdfunding.** The entrepreneur promises the funder a non-equity "token" in exchange for putting money their project. The token can be almost anything, such as a product sample, early access to a service, or recognition in the company's marketing materials. Kickstarter is an example of this form of crowdfunding and its projects range from movie production to comic book creation to a company producing premium jeans. As of July 2013, Kickstarter has attracted more than 4.5 million funders who have pledged over $700 million across 45,000 projects.

- **Crowdfund Investing.** Non-accredited investors can invest in a startup or small business in exchange for equity when they use an SEC registered crowdfunding platform. The 2,000 investor threshold (after which the company itself must register with the SEC) does not apply to these investors. This exemption was created by the JOBS Act, of 2012.

- **Regulation D Crowdfunding.** Accredited investors can use the internet and its platforms to invest equity or debt-capital in private companies. (Rule 506 of Regulation D of the U.S. Securities Act was amended by the JOBS Act to allow for this.) These investors, however, count toward the 2,000 investor registration threshold.[19]

This financing mechanism continues to rapidly grow and expand, with new platforms continually emerging. Since 2008,[20] crowdfunding has grown into a major fundraising avenue for early stage companies and small businesses, and one that eliminates many of the restrictions faced by VCs and banks.

The JOBS Act was a major turning point for crowdfunding, as it enabled entrepreneurs to offer equity to non-credited investors through these platforms. There are, however, salary-based caps that limit the amount a non-credited investor can contribute each year,[21] and a company cannot sell more than $1 million of securities annually to an unrestricted number of investors. Additionally, if the sought-after amount of financing is not reached, investors must receive their money back in full.[22]

Angels

Angel investors are individuals, or groups of individuals, who have cash, and usually expertise, to invest. Many angels are themselves former entrepreneurs who can help young entrepreneurs avoid common pitfalls while providing less structure than a VC firm. **Figure 2** summarizes the differences between Angel and VC investors.

Figure 2 Comparison of Angel Groups and Venture Capital Firms, 2012

	Angels	VCs
Number of groups/firms	301 groups, countless individuals	841
Total amount invested	$22.9 billion	$26.5 billion
Number of companies funded	67,030	3,143
Average investment per company	less than $1 million	more than $1 million
Average fund size	$1.9 million (2007)	$157 million
Primary stage of investment	Seed/start-up, early stage	Seed through late-stage
Investors	Individuals who invest from their personal savings	VC fund managers who invest on behalf of other investors (primarily institutional)

Source: Adapted from Applegate, L.M. and Simpson, K.A., "CommonAngels™ (A)," Boston: HBS Press (810-082).

Usually, angels invest without a formal timetable or process in exchange for a small ownership stake and typically without a seat on the board. Many entrepreneurs gravitate to angel investors when they require less capital than a typical VC might be interested in investing (say, less than $2 million), and when they have pre-existing relationships with angel investors such that they do not need to go through a long due diligence process. Many angel investors are interested in achieving an economic return, but many are also motivated by the thrill of being involved in early-stage start-ups. Often angel investors are seen as helping young start-ups bridge the gap between the raw idea and getting to a point of sufficient maturity and momentum that enables them to attract venture capital investment.

Angels come in many forms. Some have deep expertise in a particular domain and serve as active advisors, others devote less time to broad support but offer connections to top recruits, advisors, and other experts, and still others play a more passive role. Some, such as Reid Hoffman and Ron Conway, are prolific angels and are known as "super angels." This type of angel adds value on multiple levels, including lending their personal brands and networks to the start-ups they back.

In recent years, there has been a surge of angel investing. In 2012, over 67,000 companies received angel investments, with a total of nearly $23 billion invested from 268,000 individuals. In comparison, only 32,000 companies received angel investments in 2002. And of the 5 to 7.2 million accredited investors in the US, some 756,000 are angels.[23] Some of these active angels have formed groups (there are more than 330 angel groups in the US and Canada[24]), become professionalized, and in effect, behave like venture capitalists in terms of their thinking and rigor of analysis. Some, like the New York Angels, set a minimum annual investment amount for its members.[25]

An advantage of angel financing is that founders who choose angels wisely can often access early stage capital, business expertise and connections that help accelerate the launch of the new venture and improve its chances of success. In addition, unless the angel investor is part of an angel group that has raised a sidecar fund (see below), an angel may not have a set time-frame for achieving a return on his or her investment. There are some potential disadvantages to working with an angel investor, especially an inexperienced one. The investor may not have the expertise and connections needed by the entrepreneur. The angel investor may also be difficult to manage, especially if the entrepreneur plans to raise additional capital from venture capital investors. An additional criticism of individual angels is that, while they may make an initial investment more quickly and on more favorable terms than VC, they often can't be counted on for additional rounds of funding. When dealing with angels who are not professional investors, entrepreneurs often complain that they may not focus on the right issues at the right time, serving as a distraction for the entrepreneur. **Figure 3** illustrates how the multiple rounds of funding may play out for the angel investor and the effect of dilution over time on both the angel and the founding team.

Figure 3 Sample Angel Equity Dilution over Multiple Rounds of Funding

Stage	Pre-Money / Post-Money Valuation			Distribution of Equity Ownership				
Seed	Pre-money	Investment	Post-money	Team	Angel	VC1	VC2	VC3
	$1M	$250K (angel)	$1.25M	80%	20%	-	-	-
Series A	Pre-money	Investment	Post-money	Team	Angel	VC1	VC2	VC3
	$3M	$500K (angel) $1M (VC1)	$4.5M	61%	17%	22%	-	-
Series B	Pre-money	Investment	Post-money	Team	Angel	VC1	VC2	VC3
	$8M	$1M(angel) $2M (VC1) $5M (VC2)	$16M	45%	10%	17%	28%	
Series C	Pre-money	Investment	Post-money	Team	Angel	VC1	VC2	VC3
	$24M	$1M (angel) $10M (VC1) $15M (VC2) $75M (VC3)	$125M	11%	2%	11%	16%	60%

Source: Applegate, L.M. and Simpson, K.A., CommonAngels™ (A), Boston: HBS Press (#810-082).

Note: Pre-Money and Post-Money refer to the valuation of the company before the investment (Pre-Money) and after the investment (Post-Money). The Pre-Money valuation is negotiated by the entrepreneur and investor during the process of drawing up the Term Sheet. The Post-Money valuation is calculated as: Pre-Money valuation + Investment.

Accelerators/Incubators

Accelerator seed funding has become a highly popular source of start-up funding. An accelerator builds on the incubator model—which typically refers to an organization that provides entrepreneurs with cheap office space and proximity to other start-up entrepreneurs—and adds small quantities of equity-based funding as well as mentoring and coaching. Accelerators are sometimes known as boot-camp programs or micro-seed funds.

The business accelerator serves a valuable role in the entrepreneurial ecosystem. In the typical model, entrepreneurs apply for a limited number of spots in an accelerator, giving up a small amount of equity—in the range of 6 to 10 percent[26]—to participate. At the end of the program, entrepreneurs pitch their ventures at the accelerator's demo day.

The best accelerators are linked in with extensive networks of people in the entrepreneurship community. Your "classmates," alumni, and friends and supporters of the accelerator become part of your professional support system. And once you've participated in an accelerator, you can always associate your brand with the accelerator brand.

Accelerators are a relatively new phenomenon. Y Combinator launched in 2005 and TechStars debuted soon after, but it wasn't until 2009 that accelerators really started to take off.[27] In 2012 there were upwards of 200 accelerators worldwide and applications to those organizations increased by more than 200 percent from 2010 to 2012.[28]

Accelerators can be a good choice, especially if you are:

- **An outsider to the entrepreneurial community.** You are early in your entrepreneurial career and want to super-charge your entrepreneurial network. This is not a matter of age—you might be in your 50s and new to entrepreneurship. Accelerators can offer a speedy way to get you connected to a wide range of experts and advisors as well as other entrepreneurs.

- **An outsider to the particular city or region.** Every major innovation hub in the world now has an accelerator and most have more than one. If you are from outside a particular geographic or cultural community, an accelerator offers a great way to build a network in a rich and active startup ecosystem. Accelerators are magnets for the local leaders—events are often a "who's who" of that particular community—people you might have difficulty getting access to any other way. The quality of the mentors at the many events and one-on-one sessions over the course of the program is usually high.

- **New to fundraising.** Accelerators pride themselves, and often measure themselves, on their ability to help their graduates raise capital. For example, across twenty-six Techstars classes in its five year history, over 70 percent of all Techstars graduates have raised capital, with an average of nearly $2 million per company.[29] (Techstars publishes a chart that lists every company in every class and their fundraising status as well as employee count). If you don't have existing relationships with investors, an accelerator is a great way to establish instant credibility and tap into an instant network.

Not all accelerators are created equal and, because your personal and professional brand will always be associated with that particular accelerator, choose wisely. (One study of 29 accelerators in North America found that 45 percent of the accelerators lacked a single graduate who had secured institutional financing.[30])

Some accelerators specialize in certain domains while others have stronger reputations for fundraising or product development. To get a sense of the nature and quality of the particular accelerator you are considering, ask around about them—graduates, senior entrepreneurs, VCs, start-up lawyers, bankers and accounting firms will all have their opinions.

Accelerators are not for everyone. If you are already well-connected to a particular entrepreneurial community, have an entrepreneurial track record and network, and are comfortable with your fundraising skills and relationships, an accelerator probably doesn't make sense for you. But if those attributes don't describe you as an entrepreneur, an accelerator may be an excellent choice.

Nondilutive Financing

There is another source of funding, known as nondilutive financing, which can be highly attractive for the early development of a technology or other form of intellectual property, usually within an academic environment, and *before* the creation of company. The main source of nondilutive financing is government grants, available from many agencies such as, in the United States, the Department of Defense, the Centers for Disease Control, and the National Institutes of Health. These grants may be awarded to support exceptionally risky research before there is any certainty of commercial potential for what may result from it.

Nondilutive financing may also take the form of "translational" grants that are meant to facilitate the translation of a technology from the laboratory to the marketplace—either through licensing or through a commercial venture—by funding clinical trials and the like. The benefit of nondilutive financing is that it enables the entrepreneur to explore and refine a technology without having to deal with the expectations of investors and the complications of building a company and going to market. The financing is called nondilutive because the granting body does not take an ownership position, so the entrepreneur's share is not diluted. The academic institution, however, may have rights in the commercialization of any IP created by its employees or partners and, if you take this route, you should be sure to understand just what those rights are.

The Economics of Equity Funding

The determination of how much capital a VC firm will invest in a new venture centers around the pre-money valuation—what the company is worth prior to the VC's investment. This pre-money valuation is known in shorthand as "the pre-money" or just "the pre," and you will hear both entrepreneurs and VCs using these terms.

Pre- and Post-Money and the Option Pool

Determining the pre-money valuation is an art, not a science, and many entrepreneurs get frustrated with what seems like an opaque process that rarely, if ever, proceeds in the way you learned in finance class in business school. The valuation for entrepreneurial ventures is determined through a back-and-forth negotiation based on three factors:

1. The amount of capital the entrepreneur is trying to raise in order to prove out the first set of milestones
2. The VC's target ownership (often 20-30 percent)
3. How competitive the deal is (that is, if the entrepreneur has numerous VCs chasing them, they can drive up the price)

Pre-money valuations range widely, from a typical $3-6 million all the way up to $80 million, but the pre-money isn't the only term that defines price: the post-money plays a part as well. The post-money is the pre-money plus the money raised. That is, if a company raises $4 million at a pre-money valuation of $6 million, then the post-money is $10 million. Thus, the investors who provided the $4 million own 40 percent of the company and the management team (founders, employees, executives) owns 60 percent. A tutorial on Pre-Money/Post-Money Valuation can be viewed online at: http://courseware.hbs.edu/tutorials/prepost/.

Another term that impacts the price is the size of the option pool. Most VCs invest in companies that need to hire additional management team members to build the business, such as sales and marketing personnel and technical talent. Some start-ups begin life with a founding team that aspires to hire a strong outside executive as CEO. These new hires typically receive stock options, and the issuance of those stock options dilutes the other shareholders.

In anticipation of those hiring needs, many VCs will require that an option pool with unallocated stock options be created, thereby forming a stock option budget for new hires that will be set aside to avoid further dilution. The stock option pool typically comes out of the management team allocation (i.e., the option pool is included in the pre-money valuation), independent of the VC investment ownership. In the example above of $4 million invested in a $6 million pre-money valuation (known in VC-speak shorthand as "4 on 6"), if the VCs insist on an unallocated stock option pool of 20 percent (a typical size), then the VC investors still own 40 percent and the remaining 60 percent is split between a 20 percent unallocated stock option pool at the discretion of the board and a 40 percent stake owned by the management team. In other words, the existing management team/founders have given up 20 percentage points of their 60 percent ownership in order to reserve it for future management hires. The size of the stock option pool is thus an important negotiating element as it impacts implied price and value for the founders. The larger the pool, the lower the value for the founding team and the more value will be in the hands of new executives and employees hired.

A Sample Deal This relationship between option pool size and price isn't always understood by entrepreneurs, but is well understood by VCs. I learned it the hard way in the first term sheet that I put forward to an entrepreneur. I was competing with another firm. We put forward a "6 on 7" deal with a 20 percent option pool. In other words, we would invest (alongside another VC) $6 million at a $7 million pre-money valuation to own 46 percent of the company (6 divided by 6+7). The founders would own 34 percent and would set aside a stock option pool of 20 percent for future hires. One of my competitors put forward a "6 on 9" deal, in other words, $6 million invested at a $9 million pre-money valuation to own 40 percent of the company (6 divided by 6+9). But my competitor inserted a larger option pool than I did—30 percent—so the founders would only receive 30 percent of the company as compared to my offer that gave them 34 percent. The entrepreneur chose the competing deal. When I asked why, he looked me in the eye and said, "Their price was better. My company is worth more than seven million."

At the time, I wasn't facile enough with the nuances to argue against his faulty logic. But later, we instituted a policy at Flybridge to talk about the "promote" for the founding team rather than just the "pre." The "promote," as we have called it, is the founding team's ownership percentage multiplied by the post-money valuation.

Back to my example of the "6 on 7" deal with the 20 percent option pool. The founding team owns 34 percent of a company with a $13 million post-money valuation. In other words, they have a $4.4 million "promote" (13 x 0.34) in exchange for their founding contributions. Note that in the "6 on 9" deal, the founding team had a nearly identical promote: 30 percent of a $15 million post-money valuation, or $4.5 million. In other words, my offer was basically identical to the competing offer; it just had a lower pre-money valuation and a smaller option pool.

Note that this pricing framework assumes that the financing is the first money that has been invested in the company (i.e., it is the Series A round of financing). If there is already invested capital in the company (i.e., someone has already invested in a Series A and the entrepreneur is now raising a Series B round of financing), then the Series A investors have two competing motivations. Assuming they want to put more money into the company, they will either seek to raise capital at the highest price possible from outside investors in order to limit dilution on their earlier money (and limit the amount of new capital they put in at the higher price) or invest their own capital at a price lower than (down round) or equal to (flat round) the previous round. It all depends on how bullish they are about the company's future and how much money they have invested in the company already as compared to their target figure as a function of their overall fund size.

Liquidation Preference Another nuanced element of the economic equation of a term sheet is the liquidation preference. The liquidation preference is the governing formula for how the proceeds from a liquidity event are divided (i.e., who gets preference over whom when dividing the pie). The two pieces of the liquidation preference formula are (1) the preference calculation and (2) participation. The preference calculation is typically straightforward—those who have invested capital get preference in any liquidation over other claim holders, e.g., common stockholders who haven't invested capital, but have a stake in the company through their ownership of common stock. In some cases, preferred stockholders seek more than simply 1x their invested capital (where "x" is the amount of capital invested) and demand a 2x or 3x liquidation preference. That is, if an investor invests $5 million in a company and the company sells for $10 million, the investor gets all $10 million in the case of a 2x liquidation preference and other stockholders (i.e., common stock owners) get nothing. Under normal market conditions, multiple liquidation preferences are rare in the early stage or very competitive deals, but quite common in recapitalizations or distressed situations.

The participation feature of the preferred shares is the other part of the preference equation that the entrepreneur needs to factor in when evaluating the economics of the deal. Preferred stock participation governs what happens to the remaining proceeds after the initial preference is paid out to the investors. There are three general flavors of participation: fully participating, non-participating, and (in between) capped participation.

Fully participating preferred stock means that the preferred shareholders will share in the liquidation proceeds, after the payment of the liquidation preference, on a pro rata basis as if they had converted their preferred shares into common stock. For example, let's assume the preferred shareholders own 60 percent of the company for a $5 million investment and they have a 1x liquidation preference that is participating. If the company sells for $15 million, then the first investors get their liquidation preference ($5 million) and also get to participate in their 60 percent share of the remaining $10 million of the proceeds, or $6 million, for a total of $11 million in return to the investors.

If the preferred shares were not participating in the above example, then the investors would choose to either take their $5 million preference back or convert their preferred stock to common stock and take their pro rata share of the total proceeds, which would be 60 percent of $15 million, or $9 million—a wise choice. In the case of non-participating preferred shares, the investors are making sure their money comes out first. Once that threshold is cleared, they benefit precisely according to their ownership position. An investor with non-participating preferred shares may be misaligned with the entrepreneur in some circumstances.

Making explicit these pockets of misalignment and talking them through openly is often as critical as the particulars of the participation feature in the preferred stock being purchased. One useful technique for clarifying the various scenarios is to have a simple spreadsheet with the entrepreneur-VC split laid out under different exit outcomes. This distribution of proceeds in the event of a sale is often called the "waterfall," evoking an image of sale proceeds cascading like a river to various shareholders. Entrepreneurs be clear about what the waterfall calculations look like for each of the preferred and common shareholders.

In between the two extremes of fully participating and non-participating is a technique many VCs like to use, which is called capped participation. In capped participation, the VCs set a certain price per share threshold, under which the preferred shares are participating, but over which they are non-participating. The logic behind this provision is simple: VCs aren't in the business of giving entrepreneurs capital to make one or two times their money. Their objective, and the entrepreneur's vision, is that the company will be so successful that investors will make more than ten times their money. If a company does not live up to its promise, and there is a sale, investors want to get their money out first and they want to make a little extra in exchange for their capital being tied up over the years. This scenario is sometimes called the "sideways scenario," and VCs feel as if they deserve a preferred return under this scenario. But if things go well and the company sells for five or ten times the original purchase price, then everyone should simply get their share. In the example above, where the investors own 50 percent for $5 million, a capped participation deal might stipulate that participation stop when the proceeds are three or more times the purchase price. If the proceeds are less than threefold, then the preferred is participating, providing an extra bit of return on capital for the investor. The logic is simple for a VC investor. If a VC investor gives you $5 million for half your company, and after a few years you consume that capital to grow and sell the company for $10 million, then you turned the VC investor's $5 million into, um, $5 million. The VC investor makes nothing, and you make $5 million for yourself. Many VCs complain that this is not a fair deal.

Many early-stage VCs are advocates for "clean terms," which usually means capped or no participation and few bells and whistles around the edges to maintain alignment. The other reason early-stage VCs argue for clean terms is that they are savvy enough to know that the early-stage terms carry forward in the later stages of a company's life. Later-stage investors are likely to punish early-stage investors disproportionately if the terms are onerous, layering capital on top of the early-stage investors while inheriting all the privileges and preferences that the early-stage investors put in place. Further, if there are too many encumbrances on management, they will be negotiated away in later stages if the entrepreneurs get more leverage as a result of good performance.

Fairness and precedent may have some impact on the negotiations, but the real question is who has the most leverage in the transaction. If the entrepreneur has choices and the VC cares enough to win, they will cave on many of the key terms. The typical line you will hear within the halls of a VC partnership when pursuing a competitive deal is, "If we like the deal at $8 million pre, and we think it'll be a billion-dollar company, then why wouldn't we invest at a $10 million pre if that's what it takes to win the deal?" On the other hand, if the VC does not detect much competitive pressure and if the deal is somewhat controversial within the partnership, the VC will take a harder line on terms.

So those are the key elements of the economics—pre-money price, option pool, and participation. Now let's move on to the topic of control.

Who's In Control? Some investors play the game of "your price, my terms" where they accede to an entrepreneur's pre-money demands, but load up the option pool and the liquidation preference in such a way that the economic equation would be more favorable if the entrepreneur took a lower price in exchange for what is known as a "clean deal."

In most VC term sheets, the framework for who controls what decisions has been carefully thought through. Even the most experienced serial entrepreneurs have at most three or four data points of experience over, say, fifteen years of running start-ups, while the VC partnership has over a hundred data points over a similar period of time. Thus, the VC has seen every possible scenario where the control provisions come into play and is careful to manage these "edge cases."

There are three control elements for the entrepreneur to focus on in a term sheet. First is the composition of the board of directors. The board has the power to fire and hire the CEO and decide on major transactions, such as when to sell the company and what follow-on financings should look like. The entrepreneur who does not think through the board composition carefully can often find himself on the short end of these decisions. I urge entrepreneurs to do careful due diligence on the prospective board members, particularly by asking other entrepreneurs who have worked with the proposed board members about how things played out when problems arose or not everything went according to plan.

The composition of the board is often a reflection of the ownership split between the entrepreneur and the VC. Let's take an example of a $4 million on $4 million Series A deal, where two VCs own 25 percent each so that 50 percent is in the hands of the investors, where there is a 20 percent option pool for future hires, and the founders own the remaining 30 percent. The board is likely to be a five-member board. Typically, the smaller the board, the better, as it will be far more efficient in making important decisions. In such cases, the board is typically split as follows: two board seats for the two VC investors; one board seat set aside for the CEO (who may or may not be the founder); one board seat for the common shareholders (i.e., the founders); and one independent board seat, typically an industry expert and/or CEO in a related field whose network, experience and sage advice can add value to the company.

Do the VCs "control" the board and therefore the company in this example? Well, it depends on the fine print of board composition. If the independent director is unilaterally selected by the VCs, then, yes, they in effect control the board because they have two seats and get to choose the third without needing approval from anyone else. If the independent director must be mutually agreed to, then the VCs only control the board if the CEO or the independent director is on their side. In practice, the CEO is unlikely to go against the VCs' will if the VCs are the only source of funding (i.e., the company is still not cash-flow-positive and needs additional funding support from their VCs). Further, the VCs are often members of the compensation committee that sets the CEO's salary and bonus. As a result of the term sheet framework the VCs put in when they invested in the start-up, in practice the VCs control the board.

The second control element VCs insert in term sheets is the list of protective provisions. These are the provisions that require approval from the VCs, not just the board, to make certain decisions. The list can be long in typical VC term sheets, but the net of it is: The entrepreneur will not make any major decisions (buy any companies, sell your company, make major investments, go into debt) without VC approval. Sometimes the protective provisions are worded such that the veto power is in the hands of the board and at other times it is explicit that the veto power is in the hands of the VCs (e.g., when you see language like "requiring the consent of both Preferred Directors"). Some VCs may feel comfortable with a more independently structured board making some of the major decisions, but the control of other major decisions (e.g., when to sell the company or when to accept a new financing with new terms that change the control elements) is typically held very closely by the investing VC firms. After two or three rounds of financing, it is not unusual for the VCs to control the board and the board controls the company's major decisions.

A third important control element in the term sheet is the combination of voting threshold and drag-along rights. Voting threshold means that greater than a majority of the votes, or the preferred stock vote, is required for approval of major actions. If the VCs own most of the preferred stock, and the preferred stock vote is required for major transactions, then the VCs exert control through this vehicle. Drag-along rights mean that it does not matter how you vote your shares; if the majority or a defined supermajority vote is required for a certain action (a threshold typically set to ensure that the VCs' vote carries the day), then the other shareholders are "dragged along" and must comply with that major action (e.g., selling the company or accepting another round of financing).

All of this may sound a bit Machiavellian, but it is important that entrepreneurs understand how the VCs are looking at things. If everything goes well, most of the control-oriented term sheet provisions never come into play—it is all discussion, earnest debate, and aligned decisions. But when things go poorly and there are disagreements, the VC is often in the driver's seat to make major decisions. Only in very rare circumstances can the entrepreneur retain full control. Typically, VCs negotiate deals and make investments only when they can "control their capital"—a euphemism for controlling major decisions, particularly financial ones, in the companies in which they invest their capital.

The reason many entrepreneurs are paranoid about the control elements in a term sheet is their emotional attachment to their start-up and their fear of getting fired. Mark Pincus, founder and CEO of the wildly successful gaming company Zynga (maker of FarmVille and Mafia Wars, with over 230 million monthly active users playing its games), puts it simply: "All that we feel, as an entrepreneur, is the negative side. 'They want to get control of my company. They want to meddle. They want to second-guess me if things go bad and then, ultimately, fire and replace me.'"

The control elements in the term sheet—and the importance that both VCs and entrepreneurs place on them when the rubber hits the road—make it all the more important that entrepreneurs choose VC partners who they can trust. When a founding team takes in VC money, they are taking on a business partner. Or as Jack Dorsey of Twitter put it, "When selecting our VC partner, I knew I was hiring a boss I couldn't fire."[31] When VCs start invoking control provisions in investment documents, it is almost never a happy scenario and usually the root cause is a breakdown in trust between the VC and entrepreneur.

Let me reiterate an important piece of advice: Find a good lawyer, the earlier in the process the better. The key is to find a lawyer who has done enough VC deals that she can explain what the meaning is within each nook and cranny, while at the same time being strong-minded and independent enough from the VCs that he is not beholden to them. The most experienced startup lawyers will often defer fees until a financing. Thus, you do not need to settle for a low-quality, low-price option, particularly if you think you will eventually be funded. There are many other terms you will see in the term sheet that your lawyer can walk you through and explain, but remember to stay focused on economics and control above all else.

Conclusion

Entrepreneurs typically focus their full energies on business-building. Creating the product, solving customer problems, closing sales and building the team are the kinds of things that entrepreneurs gain the most energy from and enjoy the most when it comes to building their venture. Typically, entrepreneurs complain that spending time on financing distracts them from their "real job."

But raising capital is a core part of building a valuable business. Whether you are raising a $250,000 seed round or navigating a $100 million IPO, the capital markets—in all of their various forms—are a fundamental constituent in the business-building process.

Developing expertise in raising capital is more than a necessary evil, it is a competitive weapon. Master it and you will be in a better position to make your company a massive success.

Endnotes

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