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MuMaté (B-1): Confidential for Maxwell

As she prepared to negotiate with DuPage Ventures, Sarah Maxwell reflected on the advantages and drawbacks of two funding offers she already had in hand. Over the past several weeks, four venture capital firms besides DPV had done diligence on MuMaté, and two had presented term sheets. Jonathan Cantor of DPV was not aware of these offers; 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."

Maxwell reviewed the term sheets that she had received from Astoria Partners and Prosper Fund (see **Exhibit 1**). The term sheets were nearly identical with respect to several provisions. These provisions, which according to MuMaté's attorney were consistent with VC industry norms, 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
- Option pool to be created before Series A closes; linear vesting of employee options over 48 months after a 12-month cliff
- 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

Beyond that, Astoria's term sheet implied that they might wish to bring in a new CEO. While she was open to that possibility, Maxwell thought that she should be given the opportunity to run MuMaté until it outgrew her capabilities. 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.

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.

Similarly, she felt strongly that her partner, Taylor, should have a place on the board of directors. Taylor was, after all, the inventor and original founder, and had generated the word-of-mouth and PR buzz that had enabled MuMaté to grow so fast. Maxwell thought that it was important that Taylor have a say in the direction of the company and bring her insights to board-level decisions. Prosper had made room on the board for Taylor, but had offered a substantially lower valuation than Astoria, which had excluded Taylor from the board.

Maxwell asked her attorney for advice on how to approach the upcoming negotiation with DPV, in light of the two offers she had in hand. He replied:

> You should think about how much capital you want to raise in Series A. You've said that you need $2.5 million in external capital to get to cash flow break even. But do you want to raise that in stages—say, half in Series A and half in Series B—or in one big round? If you stage the rounds and you are successful over the next year or so, you'll sell Series B shares at a big premium over your Series A stock price—maybe 2x—and you'll suffer less dilution. But if you stumble, Series B would probably mean a down round with big dilution for you, if you can raise a round at all.
>
> For a Series A startup with a single investor, you should recognize that VCs strongly favor a three-person board with one independent director. But startups with two strong co-founders can sometimes bargain for two founder seats, as you've done with Prosper. Also, try to think about the size of your option pool not only in terms of how much dilution it costs you personally, but also what's right for the business. Series A option pools typically range from 10% to 20% of fully-diluted shares; the more managers you will be hiring, the bigger the pool you'll need. Finally, I know you think that founders' shares should not face any vesting restrictions at all, but Prosper's terms are fairly typical and Astoria's are generous.

Maxwell had negotiated hard with both Astoria and Prosper, and did not believe that she could further improve their terms. She felt she could live with either deal, but she had serious reservations about each. Frankly, she wasn't sure which of the two VCs she—or Taylor—would choose if they were not able to negotiate better arrangements with DuPage Ventures. Dank, meanwhile, thought they should avoid VCs altogether. He said they would suffer much less equity dilution by relying on a combination of angel investors and asset-based lending.

Exhibit 1 Analysis of Term Sheets from Astoria Partners and Prosper Fund

	Astoria Partners	**Prosper Fund**
Money raised/ Pre $/Post $/ VC Stake	$2.5M raise + $7.5M pre = $10.0M post (VC =25.0%)	$3.0M raise + $4.5M pre = $7.5M post (VC = 40.0%)
Board	• 3 members: founder/CEO; VC; outsider suggested by MuMaté and acceptable to Astoria • Upon hiring new CEO, board increases to 4, with new CEO taking additional seat	• 4 members: 2 founders; VC; outsider suggested by MuMaté and acceptable to Prosper
Option pool	• Option pool = 17.5% of fully-diluted shares after round closes	• Option pool = 12.5% of fully-diluted shares after round closes
Founder share vesting	• 33.3% on closing; remainder vest linearly over 24 months • Unvested shares subject to buyback at fair market value	• 25% on closing; remainder vest linearly over 36 months • Unvested shares subject to buyback at fair market value
Other key provisions	• Funds to be disbursed in two $1.25M tranches, with Astoria acquiring an equal number of shares upon disbursement of each tranche. Astoria is obliged to release 2nd tranche after MuMaté achieves revenue of $10M and positive EBIT over a 12-month period. If these milestones are not met by year-end 2013, Astoria is not obliged to fund 2nd tranche.	
VC reputation	• Astoria, a middle-of-the-VC-pack performer, was rumored to be struggling to raise its next fund, so the firm was under pressure to show good returns on its current fund • Astoria was reputed to be more likely to replace founders than other VC firms • MuMaté co-founders respected the industry acumen of the young partner who would be their board member; they had heard he was "very opinionated and hands on."	• Prosper current fund was on track to earned attractive returns for limited partners • Partner who would be board member lacked packaged goods experience but had a long/strong track record in consumer tech investing; she was said to be a good coach who offered sage advice on startup management and "trusted a founder/CEO to run things."

Source: Company records.