Inside the Black Box of Venture Capital

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Topics

- VC at 100,000 feet.
- Legendary founders and legendary startups.
- Fundraising from VCs (dos and don’ts).

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Before we get started, I acknowledge that…

- Not all VCs are universally liked;
- They sacrifice less than founders and are often overpaid;
- Only 3% of VC Partners generate >3x in their careers, but almost all of them get rich no matter what;
- There is not nearly enough diversity in the VC business; It’s even worse than the already-bad tech industry;
- A lot of VCs would not succeed if they had to run a startup.

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Just so you know my many screw-ups (so far)…

I passed on these…

airbnb
AppDynamics
zynga
trulia

These got away…

Pinterest
GitHub
YouTube

This was my (positive) experience with VCs …from the entrepreneur perspective

Tivoli software

KPCB KLEINER PERKINS CAUFIELD BYERS

matrix PARTNERS

AustinVentures

NORWEST VENTURE PARTNERS

motive

ACCEL PARTNERS

SILVERTON PARTNERS

AustinVentures

Part 1:

VC at 100,000 feet

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The Venture Capital Food Chain

Limited Partners (LPs)

Venture Capitalists (VCs)

Entrepreneurs

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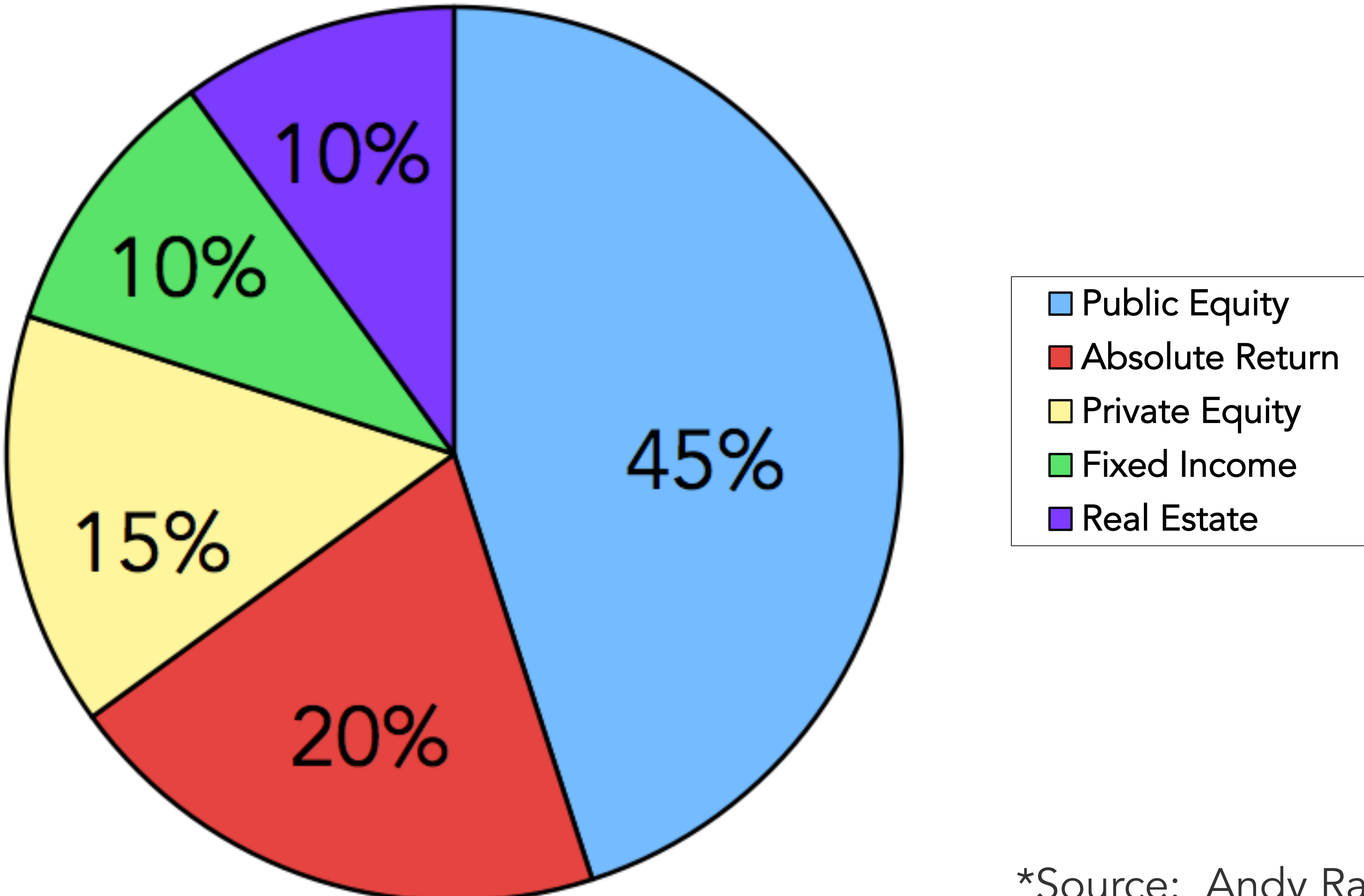
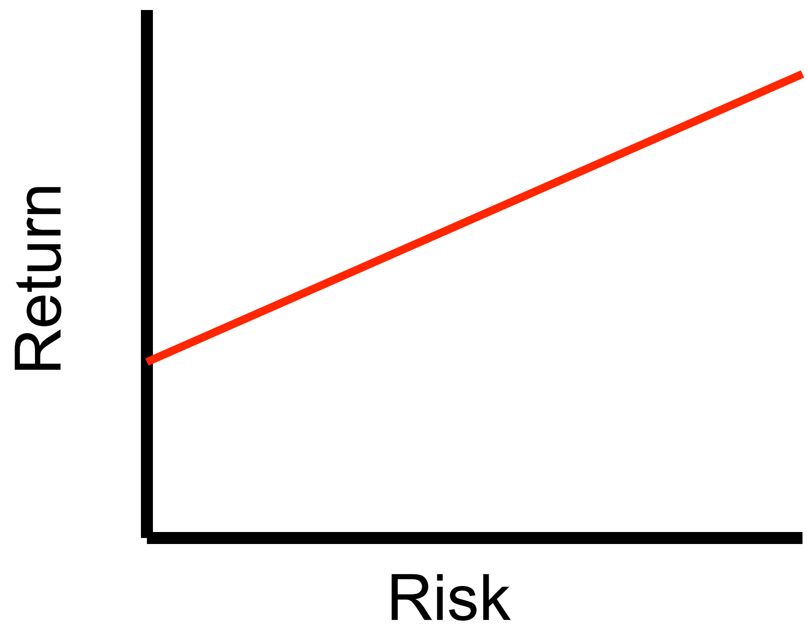
Asset Allocation for a Limited Partner (LP)*



*Source: Andy Rachleff – Benchmark Capital

The Trade-off Between Risk & Return: LP Perspective*



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*Source: Andy Rachleff – Benchmark Capital

You are an LP: How would you rather see a VC invest $10 million?

- Fund I
  - Makes 10 $1M investments
  - Makes 2x their money on every investment
- Fund II
  - Loses all their money on 8 and
  - Gets 20x their money on the remaining 2
- Fund III
  - Loses all their money on 9 and
  - Gets 50x their money on the remaining 1
- Accel XI
  - Invest $10M in Facebook at $100M post

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Key Thought:

VCs are paid to take high risk for high return. It's the only reason LPs invest in VCs.

VCs depend on legendary entrepreneurs, technology discontinuity, and luck to create the massive outcomes that make the model work.

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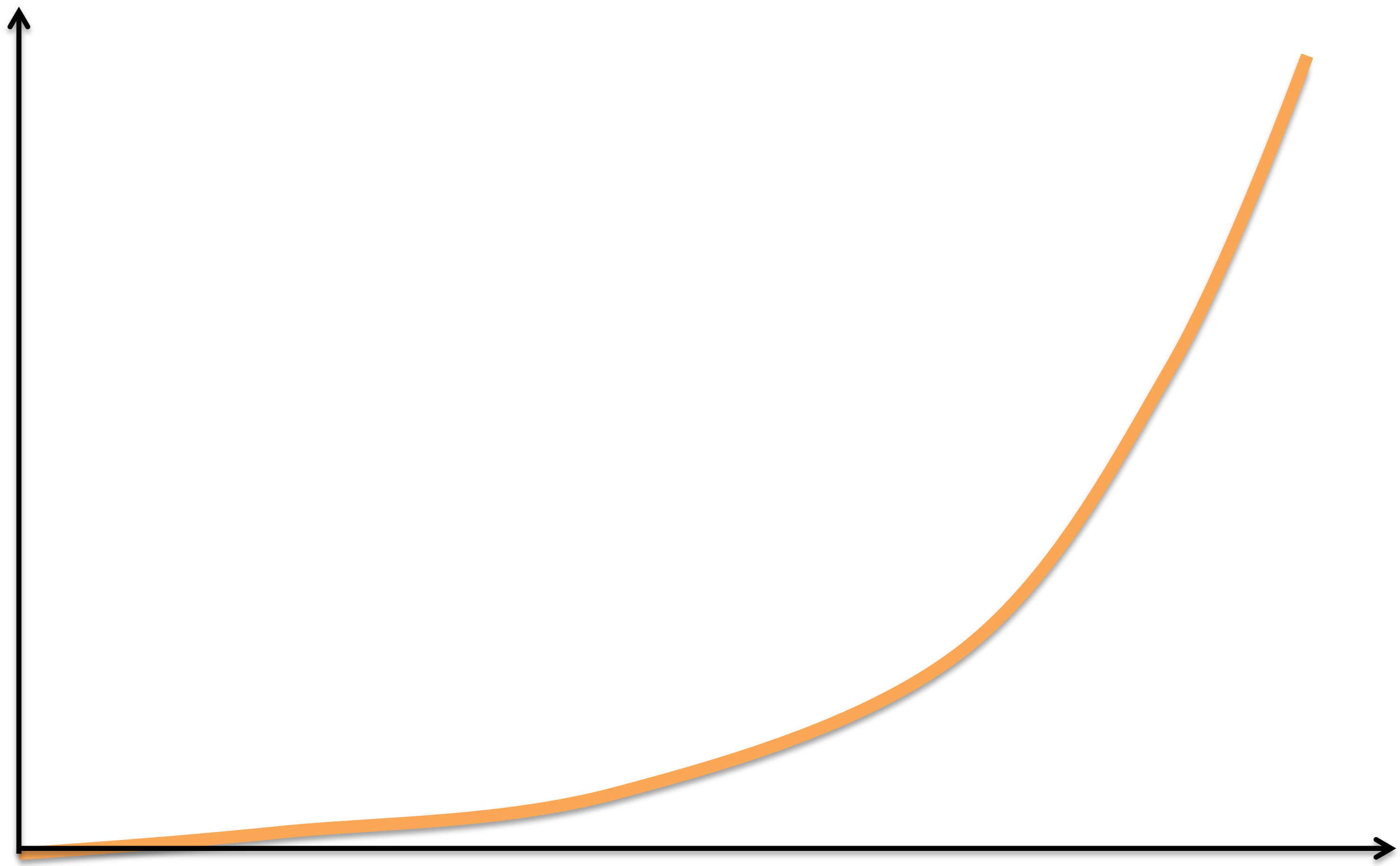
Part 2:

Legendary Founders and their Startups

3 Exponential Laws of Tech Startups

Moore's Law



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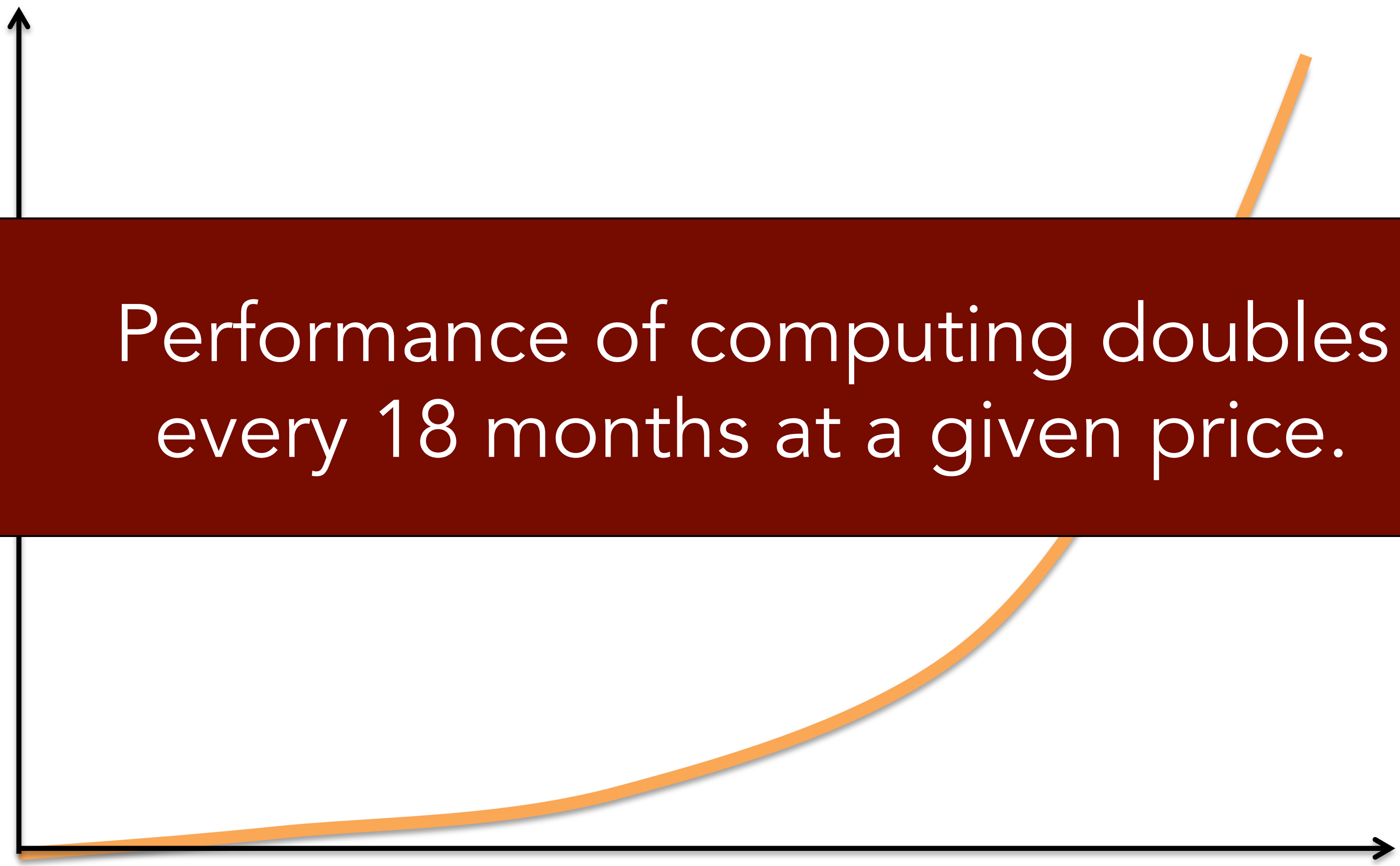
Moore's Law



Performance of computing doubles every 18 months at a given price.

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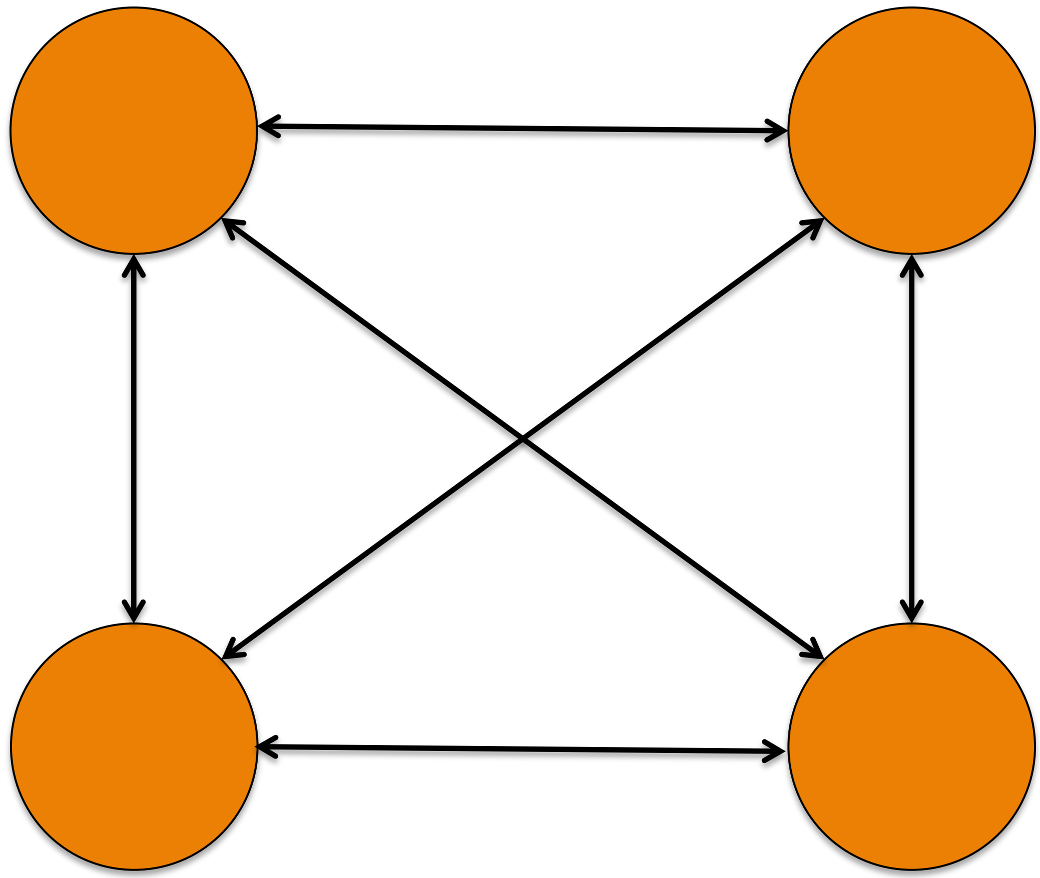
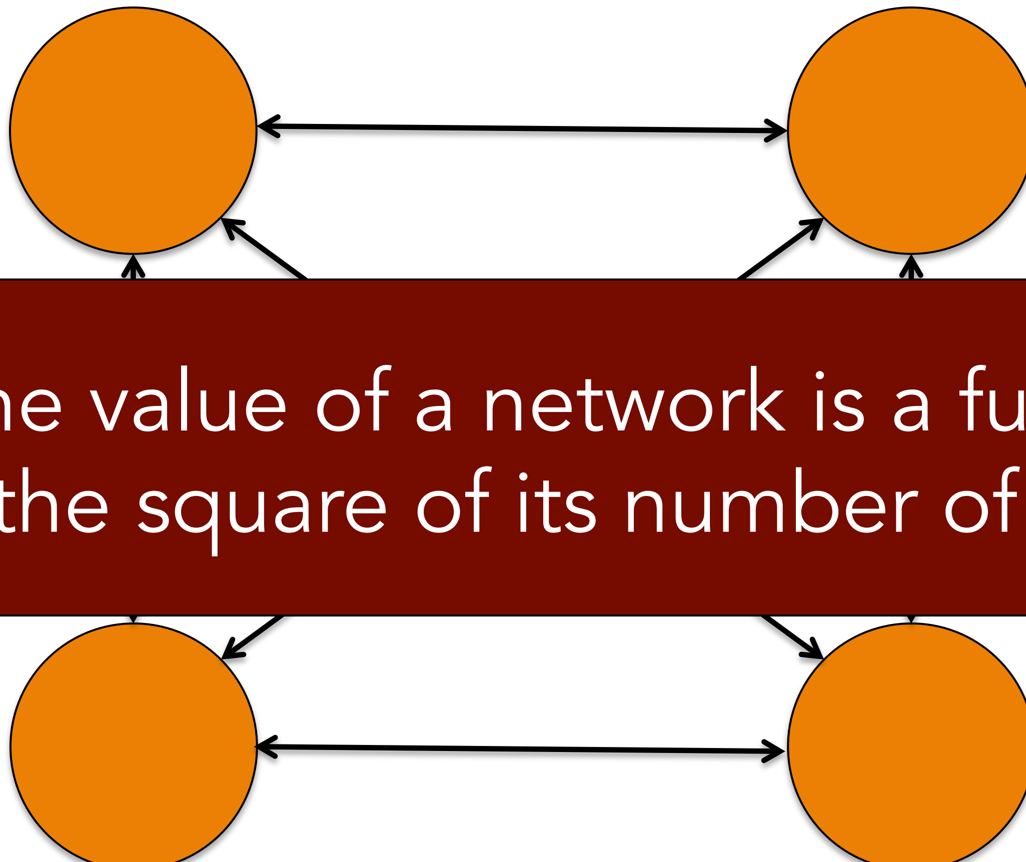
Metcalfe's Law



Metcalfe's Law



The value of a network is a function of the square of its number of nodes.

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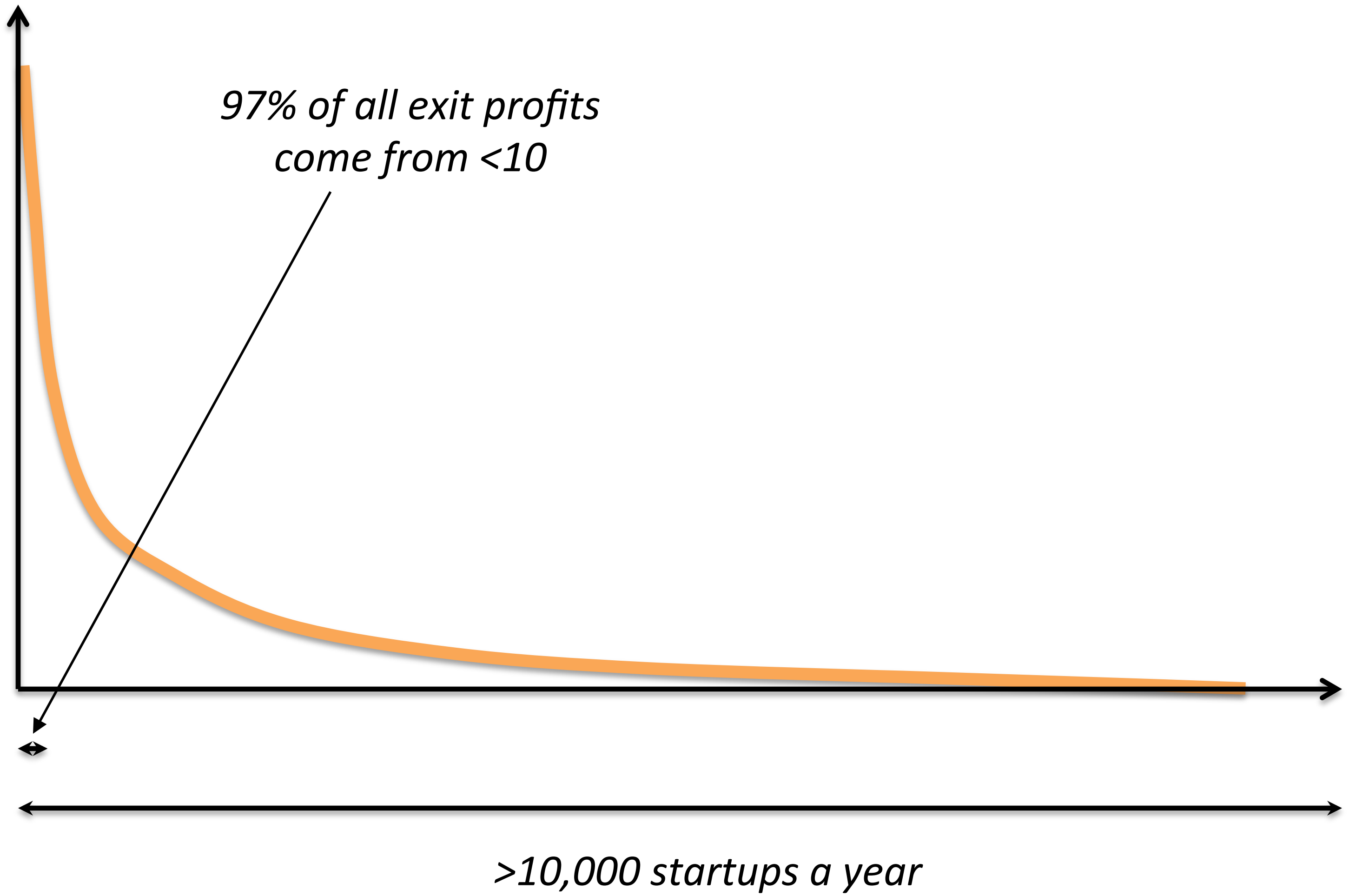
The Power Law



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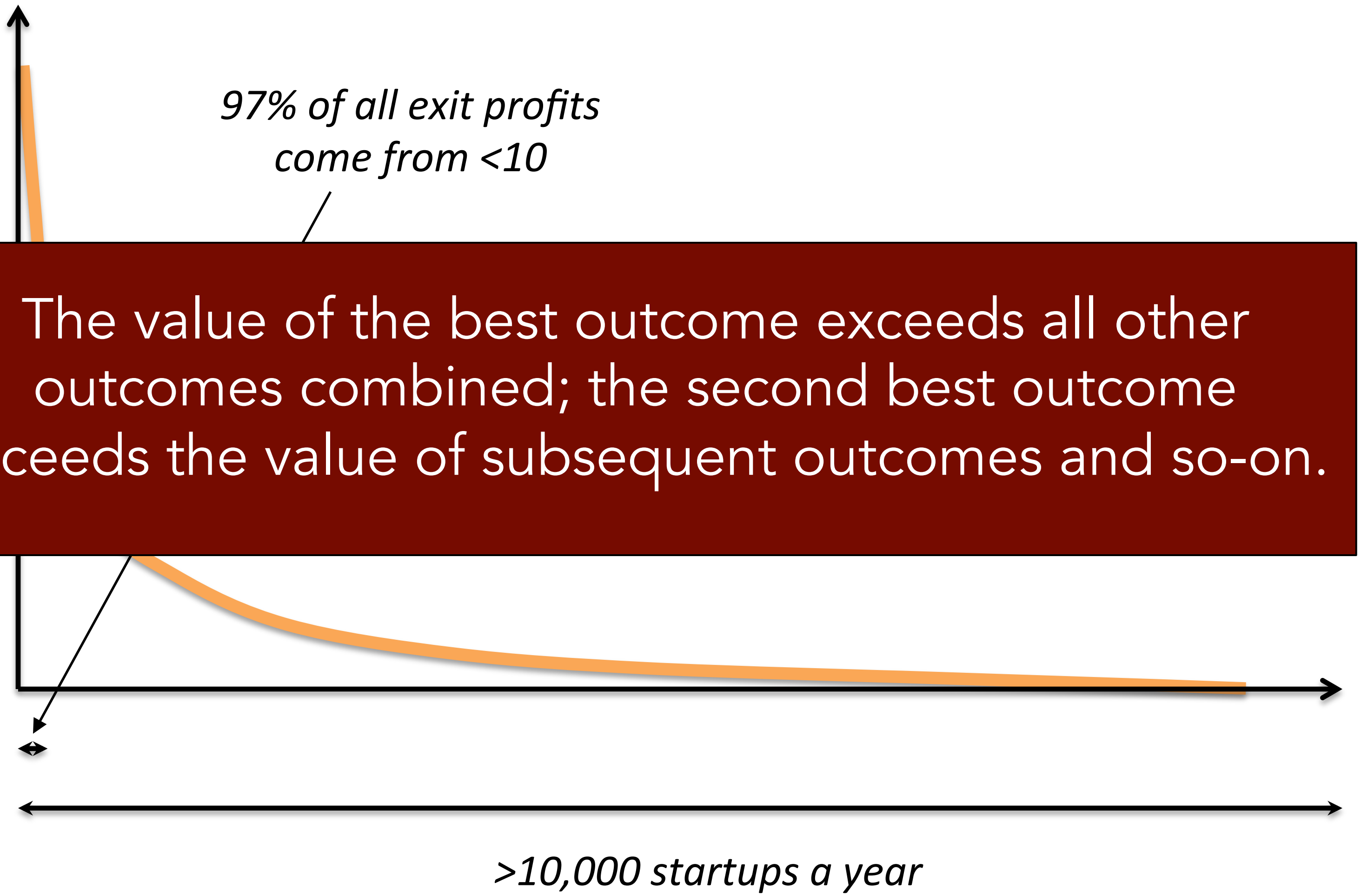
The Power Law



The value of the best outcome exceeds all other outcomes combined; the second best outcome exceeds the value of subsequent outcomes and so-on.

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The Power Law in Practice

- 10,000-20,000 companies will be funded by Angels
- 1,000-2,000 will get VC funding
- 50-100 are "OK, but not great" (exit > $50M)
- 10 +/- 5 will be special (exit > $500M)
- The best company in a given year will usually be more valuable than all other 9,999 companies <u>combined</u>

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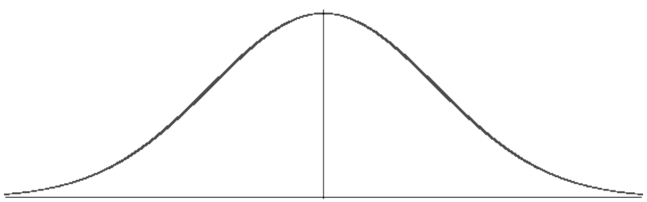
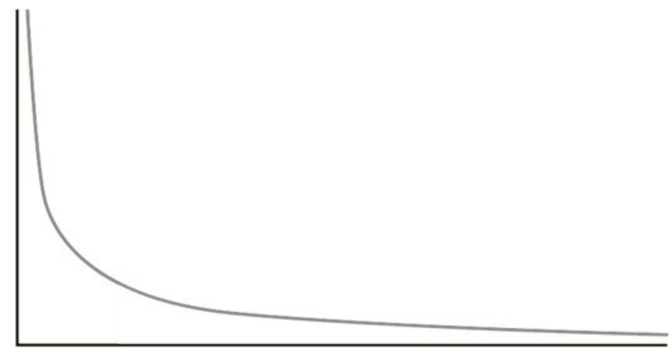
The Power Law: What It Means

Startup outcomes do **not** follow a “normal” distribution



…they are governed by <u>exceptionalism</u>



- Maples Angel
- Maples Fund I
- Y Combinator
- Exits in a given year
- Exits in a given decade

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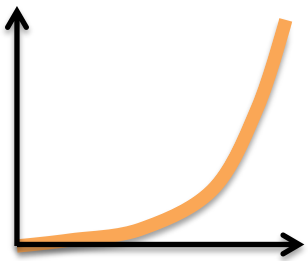
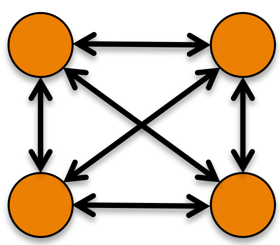
The Goal of a Tech Founder





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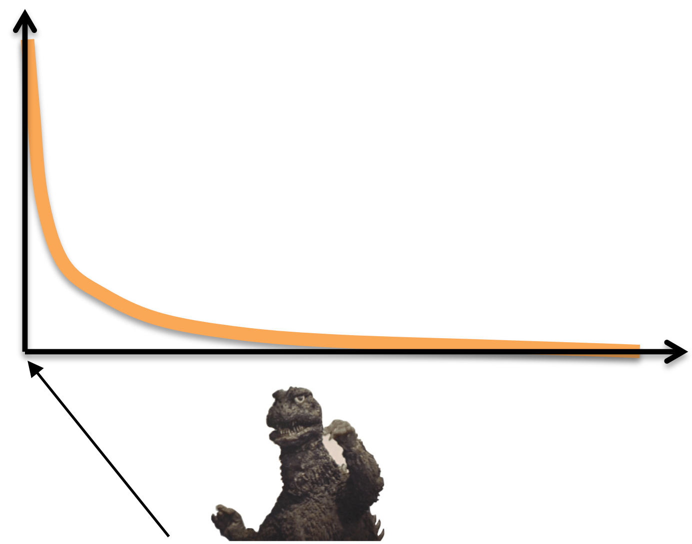

Leverage the power of Moore's Law and/or Metcalfe's Law…

An extraordinary outcome

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Part 3:

Fundraising from VCs

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Don’t let these things happen to you!

Gotcha #1…

"Happy Ears"

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VCs have very little incentive to tell you exactly what they are thinking

- If they "pass" on your deal and it becomes awesome later, they might lose out.
- The more time they have to evaluate your company, the more info they can gather. As long as it doesn't cost them to take more time, they often will.
- The VC will often give a "reason" for passing that doesn't reveal what they really think, oftentimes not to offend the entrepreneur.
- VCs often lead founders on, but many founders lead *themselves* on because they read too much happy talk into the pitch meetings.

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Why else might a VC be hard to read?

- Sometimes we really don't know what we think after a meeting.
- We constantly have to make decisions about things we can't fully understand and predict and we know we are often wrong.
- Bombarded with pitches; perhaps I liked yours but just didn't fall in love yet. It happens…
- Sometimes I can't describe what I "don't like." It just didn't get me excited enough to take the next step or stop diligencing what's already on my plate.

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If a VC does not insist on a follow-up meeting that happens in <2 weeks…

- They are almost certainly not going to invest in the next 6 months (unless you are so successful you no longer need them.)

- They might say "the space is too crowded", they are "not funding your market", that they "can't get the partners to agree to do it", etc., etc., etc.

- You can only **"know"** one thing: **You didn't get the VC to say yes.**

- As an aside, this is why you should respect (and not resent) the VCs who tell you the real reason they are passing.

- Another key point: It follows from this that when you tell other VCs the "logical reasons" that other firms passed, you look unsophisticated.

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Gotcha #2:

Thinking you are in a traditional "sales cycle"

After a VC passes

- If your goal is to get money from them in the future, your job is to be awesome next time you see them.
- Addressing their "objections" from the last meeting likely won't work. That's not how they make funding decisions.
- Every future meeting is a clean slate opportunity to demonstrate you are awesome.
- Don't assume they remember clearly why they passed the first time. They probably don't!
- Remember: <u>All you really know is they passed the first time.</u>

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Gotcha #3:

“Sequoia Game Theory”

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NEVER say to a VC…

"We are talking to Sequoia"

(or somebody awesome like them)

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Why?

- Many VCs will assume you would take Sequoia's money if it is offered.
- If that's the case, there is no point giving you a term sheet now….Better to wait and see what Sequoia does.
- If Sequoia passes, one of two bad things happens to you…
  - The VC might think he/she has negotiating leverage with you since Sequoia is gone
  - Even WORSE, the VC might assume Sequoia passed for a good reason.
- There is only one good answer to "who else are you talking to…"
  - "The usual suspects."

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Gotcha #4:

Talking to people who won’t invest without another lead

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Getting the <u>first lead offer</u> is the hardest part

- You have to estimate not just the probability that an investor will say yes, but that they are willing to be <u>the first to say yes</u>.

- If I were a founder evaluating a VC, I would want to know if they are willing to decide quickly and *on their own*.

- An investor who will only invest once you have a lead is *worthless* at first. Pitching them early has no upside; only downsides.

- An investor who says "I will lead a $2M round by investing $1M if you find another $1M is *not* leading." They have done nothing for you. You have made no real progress.

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Gotcha #5:

Trying to raise without a compelling growth story

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Raise when you can tell a compelling growth story

- Many founders raise because they need the money. (Duh! ☺)
- VCs don't care about <u>your</u> need for money. They care about how you will leverage Moore's Law and/or Metcalfe's Law to create a <u>killer growth story</u>.
- When VCs say "yes" or "no", it's not about whether they are willing to make a bet on you…It's not personal.
- Never forget, a rapid growth opportunity combined with a killer team is what makes a startup VC-backable.
- Also remember: Compelling is in the eye of the beholder. You must know what compelling is <u>***in your market***</u>. (this is where many founders are falling short without knowing it.)

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Gotcha #6:

Believing it’s “all about the team” or “this is a bet on me.”

Teams and Markets*

- "When a great team meets a lousy market the *market wins*

- When a lousy team meets a great market the *market (sometimes) wins*

- When a great team meets a great market *something special happens."*

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*Source: Andy Rachleff

Who is the ideal funding source?*

Potential Market Size	Ideal Funding Source
Small	Bootstrap or Angel
Unclear	Bootstrap or Angel then VC
Large	Venture Capital

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*Source: Andy Rachleff

Things I <u>have</u> seen work…

A few best practices for VC pitches

- The 30 Second Pitch
- The 2 Minute Pitch
- Tight Investor Meetings / Process

- Extra Credit
  – Value Stack and 6/10 Law

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Best Practice #1:

The 30 Second Pitch*

30 Second Pitch

What does your company do?

How big is the market?

What is your traction?

So What?

*Source: Michael Seibel, YC

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30 second pitch

EVERYONE IN THE COMPANY SHOULD KNOW IT

- What does your company do?
- How big is the market?
- How much traction do you have?

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What does your company do?

- Super simple and straightforward;
- Assume your audience knows literally nothing;
- There is always a 1-2 sentence explanation.

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GOOD

airbnb

"We are Airbnb. We let you rent out the extra room in your house."

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BAD

airbnb

"We are Airbnb and we are a marketplace for extra space."

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How much traction do you have?

- Ideally 30% a month in an important area (sales, revenue, users)
- What if you <u>don't</u> have traction?

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If you don't have traction, must show you are moving *super fast*

- Team started in January
- Everyone full time
- Interviewed 50 customers in February
- Beta in March
- Launched in April
- Next release in 2 weeks
- Moving fast, thinking like a startup
- If no traction, make sure you are realistic about the size of the raise.

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How big is your market?
GOOD

Chegg®

- We are Chegg and we rent textbooks.
- 20M students a year spend $30B on textbooks.
- If people spent a third as much to rent as to buy, we only need 10% market penetration to do $1B in revenue a year.

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How big is your market?
BAD

- "Recruiting is a $500B market and it's broken."
- "5 companies in our space have raised more than $10M and we have accomplished more than them with far less."
- "We are (name your solution) for Millennials."

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So What?

- This is your final flourish
- Your chance to say what victory looks like
- Your "computer on every desk and every home" statement. Your "index the entire world's knowledge" statement.
- The "what happens when we totally win" statement.

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Example of the "30 second Pitch" for Chegg

- We are Chegg. We let college students rent textbooks.
- Students spend $30B a year buying new textbooks. If we rent them out for 1/3 of the price, we can sell $1B a year with only 10% market share.
- We launched a pilot of our textbook rental service at 3 schools and over 10% of students signed up, with the average student renting 3 books.
- People love this service. It's working. It's unstoppable. We think it will be in every college in the next few years. Think back to when you were in college. Why would anybody buy a textbook if they could rent it?

Best Practice #2:

The 2 Minute Pitch*

2 Minute Pitch

30 Second Pitch Plus…

Your Unique Insight

How you make money

Team

The big ask

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*Source: Michael Seibel, YC

The 2 Minute Pitch

- Probably talking to an investor or someone who can do something meaningful for the company
- 30 Second Pitch *Plus*
- Your Unique Insight
- How do you make money?
- Team
- The big ask

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Your Unique Insight

- Your opportunity to tell me something I don’t know and most of the world doesn’t know;
- Your billion dollar secret;
- The “a-ha” moment in two sentences;
- The unconventional wisdom;
- You will see the “a-ha” in the person if you got it right;
- See @m2jr Medium Post “Finding Billion Dollar Secrets.”

How will you make money?

- Don't run away from it; just say it and move on;

- If it's ads, say it. If it's virtual goods in games, just say it; If it's direct B2B sales, just say it;

- The trap is to say a bunch of stuff…which says you have no idea…which means you said less than nothing.

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Team

- If your team has done something impressive that made money for someone, you should call it out (e.g. – we are the founders of Bazaarvoice)
- Don't talk about awards, PHDs, merit badges, etc.
- What is the mix of people? Who is technical? Who is business?
- Are you all working full time?
- How did you meet? How long have you worked together?

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The Big Ask

- How much money are you raising? Convertible note or equity? Why?
- What is your Range? (Minimum viable raise to grow at an acceptable rate?; How much faster can you grow with more money?)
- NEVER say "we can't do A, B, or C until you give us money…" This is unempowered and weak.
- …Instead "This is moving fast. We've quit our jobs. We are coding. We are meeting customers. We are cranking."
- The less traction you have, the more you have to be willing to raise less.

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Best Practice #3:

Effective investor meetings*

Effective Investor Meetings

Warm Intro

Think Parallel

1 Team Member

*Source: Michael Seibel, YC

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Warm Intros

- Another founder from another awesome startup;
- One of your current investors who loves you;
- NEVER someone who passed on you;
- The person making the intro should be AWESOME and say YOU are awesome.

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Think Parallel

- Fundraising is a Sprint; If you turn it into a Marathon you lose.
- Schedule all of your meetings in a single week 3 weeks out into the future if you can; 2 weeks of meetings is OK, but close to the limit;
- "We would love to set up a meeting but we are building like crazy and dealing with inbound customer interest the next two weeks. Can we schedule something three weeks out?"
- Gives people time to get you on the calendar all in the same week;
- Communicates confidence and focus on customers, not desperate need for money.

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1 Team Member

- When multiple people are fundraising, it takes time away from growing the company.
- Even worse, if everybody does fundraising, it becomes top of mind for everybody.
- Should be the CEO. Even if CEO is a coder and not a sales person.
- OK to bring more people if it is close to the last step in getting to Yes.
- Bad sign if the rest of the team doesn't trust the CEO to handle. Could be deeper issues.

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A couple of new things from the Floodgate Weapons Lab

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2 New Frameworks

- The Value Stack
- The 6/10 Law

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The Value Stack

Value creation

Category Power	*…captures the value from changing spend*
Company Power	*…prepares for rapid scaling*
Product Power	*…achieves product-market fit*
Proprietary Power	*…avoids the need to compete*

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More info on the Value Stack

Check out “Floodgate Value Stack Primer,” Mike Maples, Jr

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The 6/10 Law*

*Inspired by insights from collaboration with Play-Bigger

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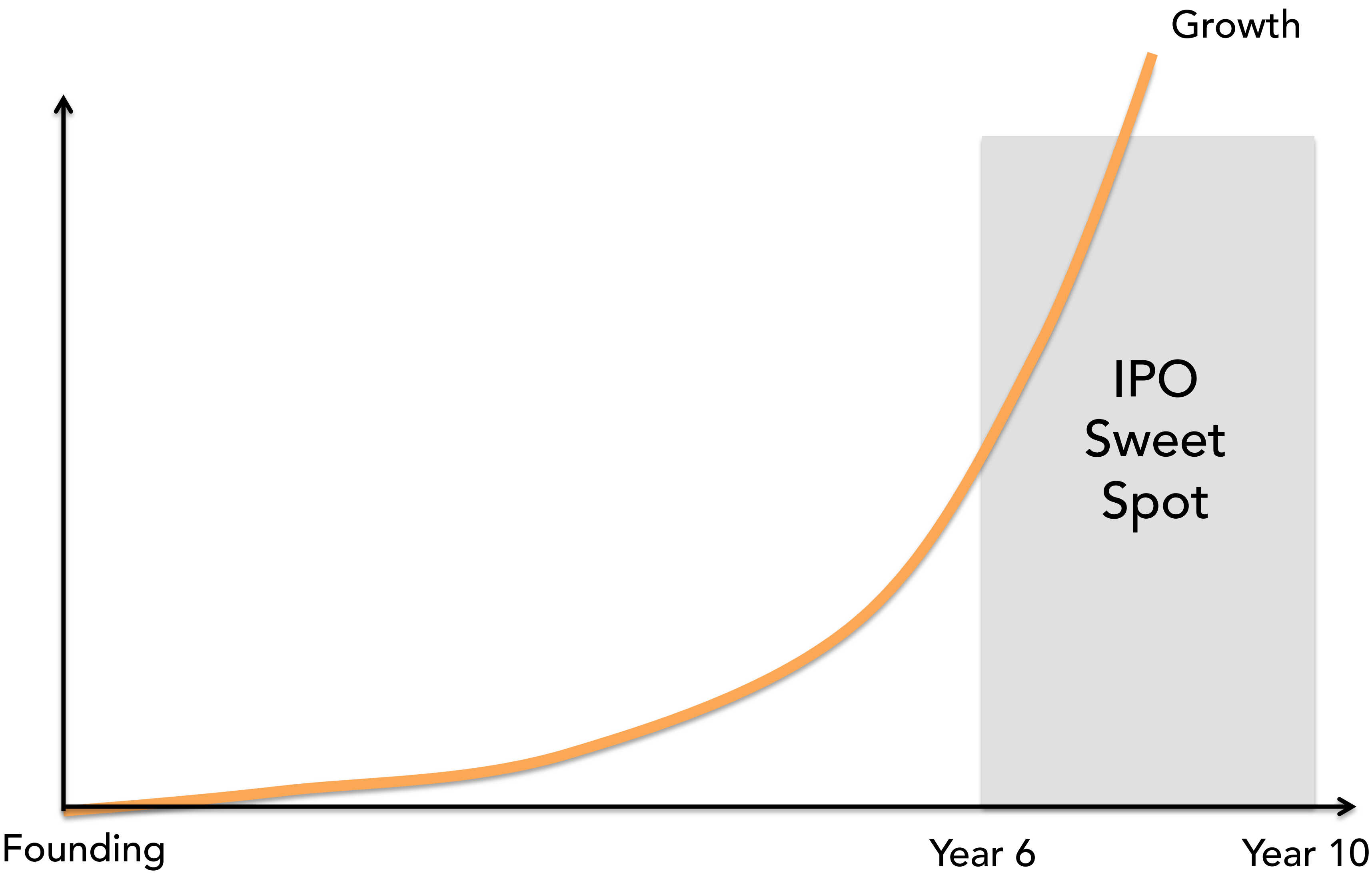
Key Floodgate Growth Framework – The "6/10 Law"



6/10 Law - Process

- Select 3 Analogous Companies (high, medium, low success) with similar business models
- All 3 should have gone public
- Thought Experiment:
  - Can we grow at those rates?
  - How much money did they need to raise and when?
  - When were they IPO-ready?
  - What did their businesses look like? Revenue, growth, margins, G&A, R&D, etc.

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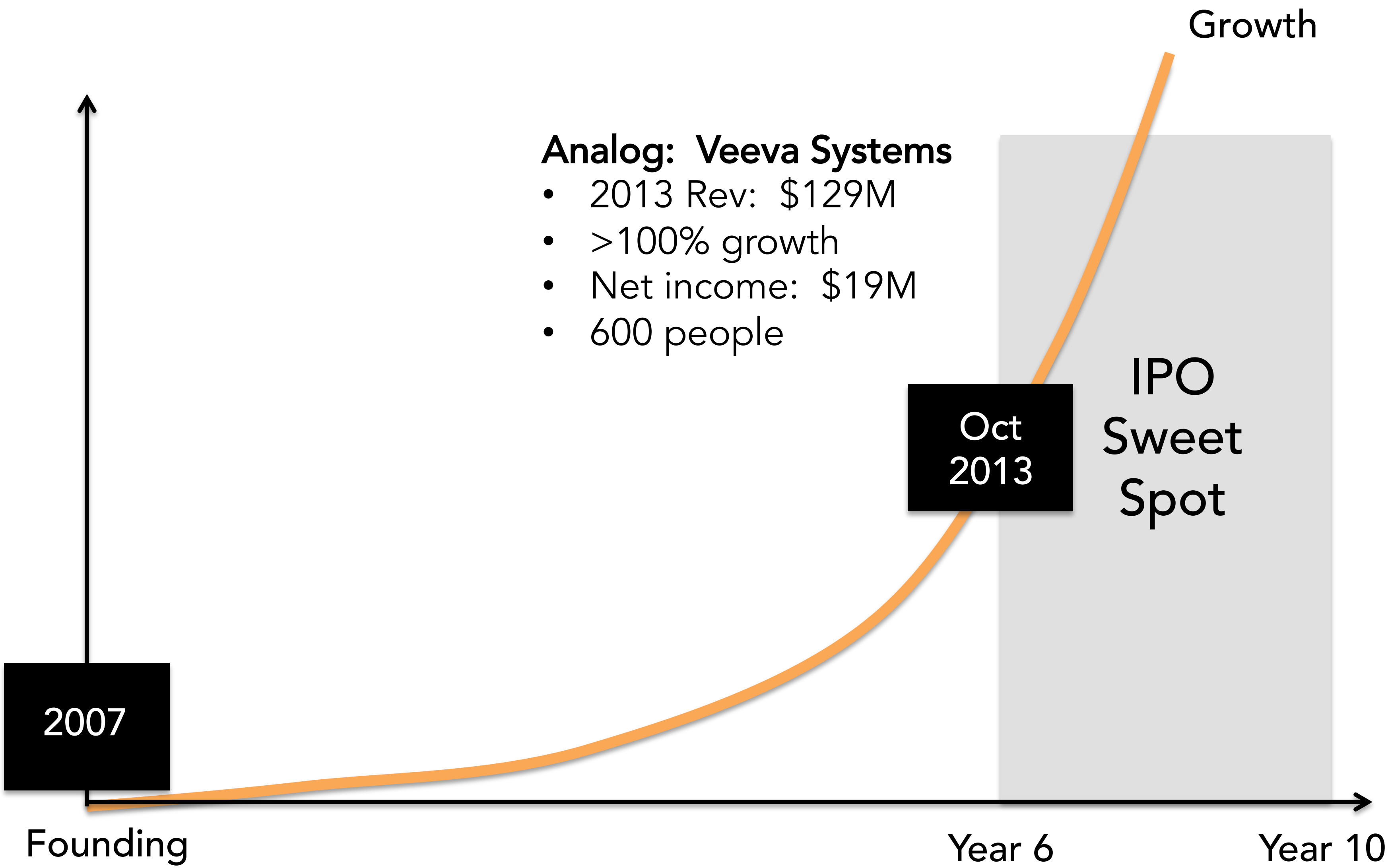
Example Recent FLOODGATE investment in vertical Saas: Dispatchr



But we are a "consumer" product…

- Google, Facebook, Twitter and LinkedIn all went public in the 6-10 window
- Are you building your consumer network at a comparable rate?
- Are you planning to monetize at roughly the same time?
- How will your company benchmark to theirs if you dominate your opportunity? (users, revenue, engagement, margins, market share, etc?)

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Applying the 6/10 Law

- We are <u>not</u> saying…All companies should go public
- We are <u>not</u> saying…You should pitch the 6/10 Law to a VC
- We <u>are</u> saying…6/10 Law is a diagnostic test for you the founder
- We <u>are</u> saying…In a crowded world of "lean startups", let's go beyond…
  - Playing checkers with one round at a time (this is chess!)
  - "Just" a product roadmap. Great founders also seek a <u>growth</u> roadmap.
  - Not just an MVP that evolves; a money-making machine in the future.

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Final Best Practice…
The most important of them all.

Be AWESOME and syndicate the TRUTH.

THANKS !

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Special Thanks to…

- **Andy Rachleff**, co-founder of Benchmark Capital.
- **Michael Seibel**, **Tyler Bosmeny**, and the **Y Combinator Team** (their podcast on *How to Start a Startup* is awesome.) Michael and Tyler are legendary founders we are super proud to have backed.
- The Play-Bigger Team of **Christopher Lochhead**, **Kevin Maney**, **Dave Peterson**, and **Al Ramadan**.
- All of the founders of the world who dare to be legendary.

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