Starting Up: Some of the Basics

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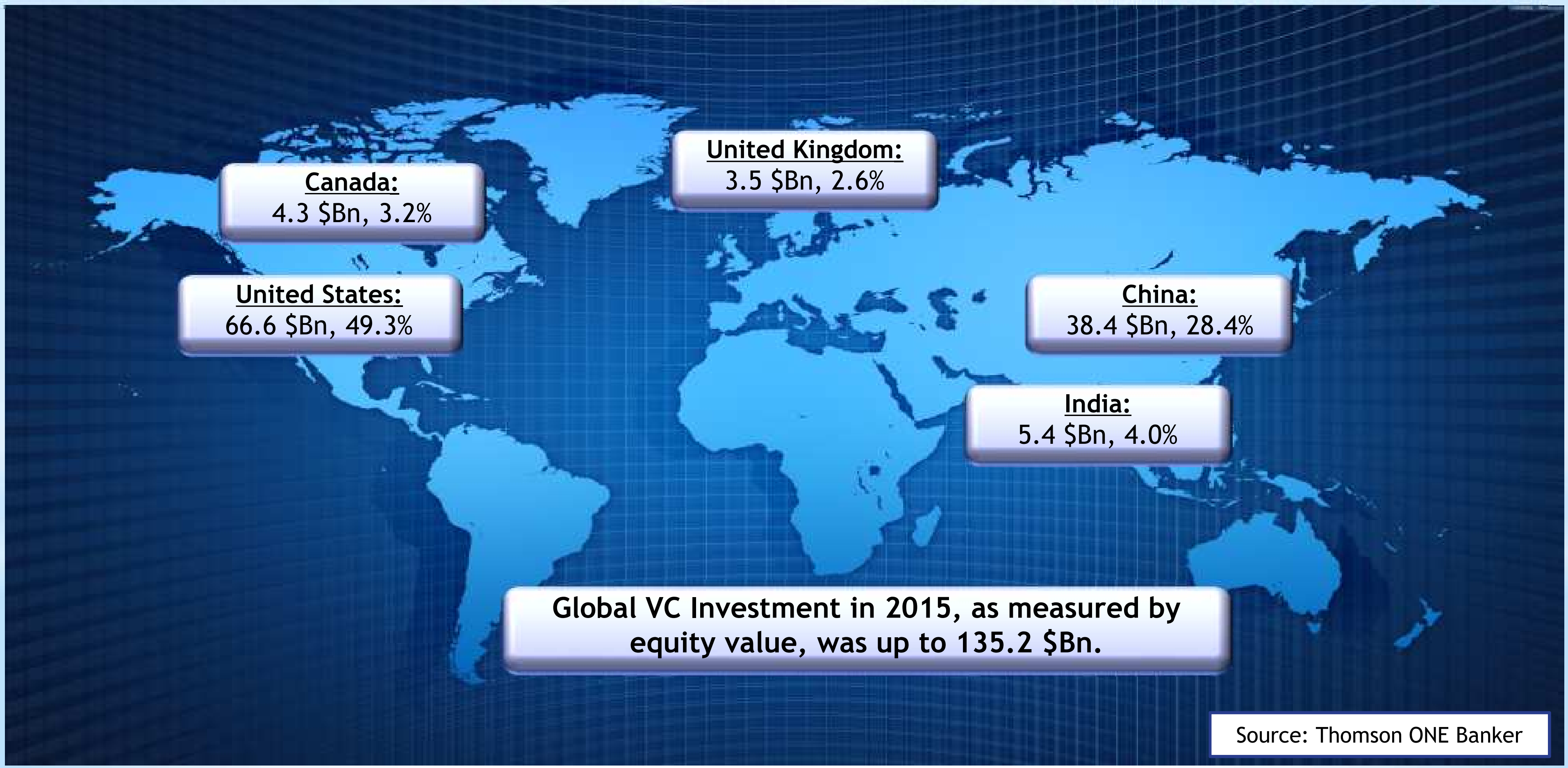
Industry Snapshot*

***Caveat to this presentation**: *Observations and insights are framed exclusively in the context of a U.S. venture-backed startup company.*

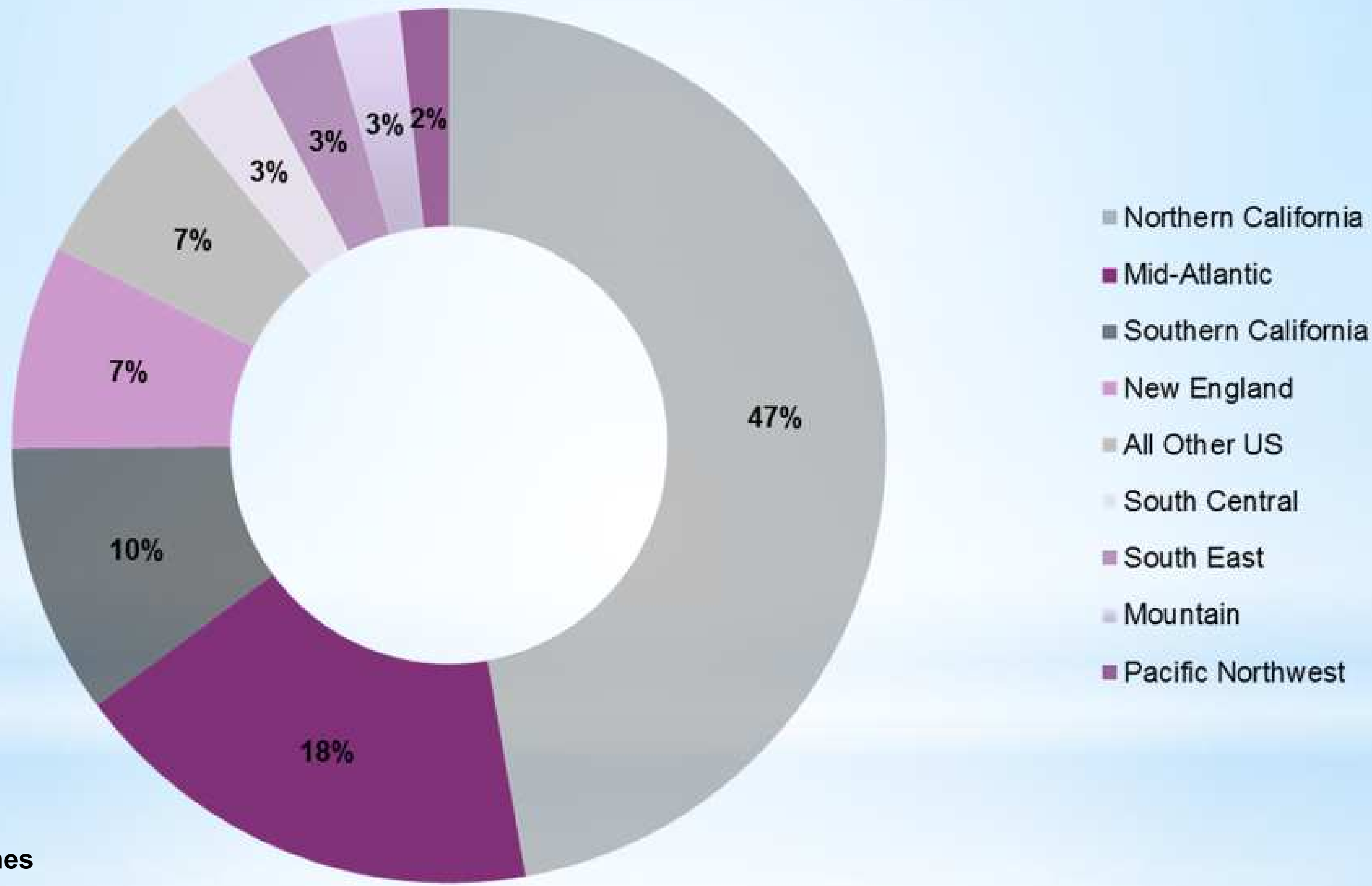
Global VC Investment In World Nations In 2015

(Equity Value, $Bn)



VC Industry In The U.S Today

Regional Investment Dollars In The United States Q4 2015



Source: DowJones

Industry Cycle
Q4 of 2015

Limited Partners

ROI for the asset class

Supply of funds

Interest rates

VC Firms

Number of VC Firms

Number of professionals

Money invested

Seed Stage Investments

Number of deals

Valuation levels

Series A Rounds

Number of deals

Valuation levels

Number of failed companies

Series A crunch

Later Stage Rounds (Series B+)

Number of deals

Valuation levels

Series B crunch

IPO Exit

Number of IPO's

Time to IPO

Valuation levels

"Private IPO" Exit

Megadeals
($40m +)

M&A Exit

Number of deals

Time to exit

Valuation levels

Organic buyers

Private Secondary Market Exit

Emergence of secondary
funds

Working Capital to Companies

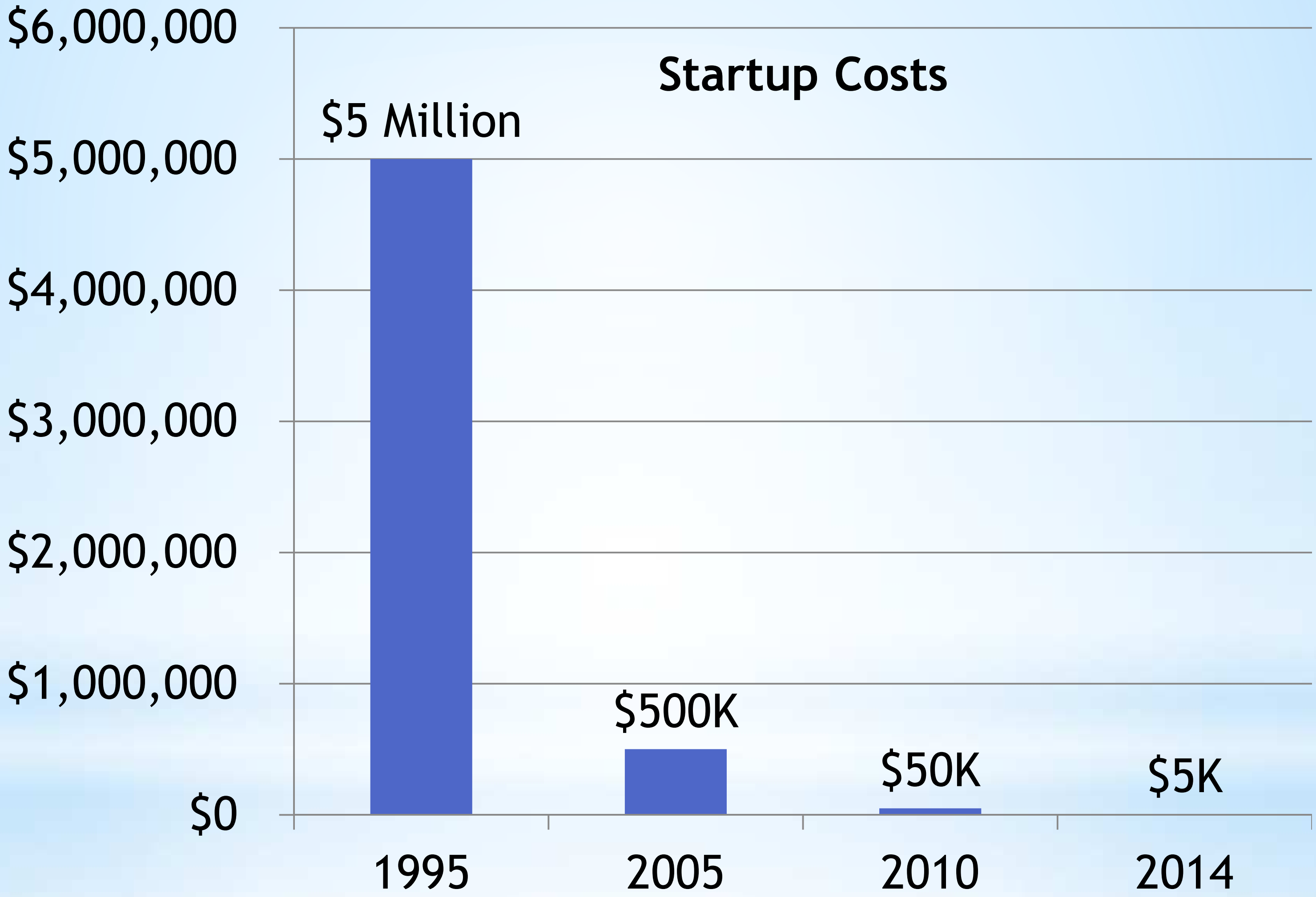
Financing alternatives

Sector growth

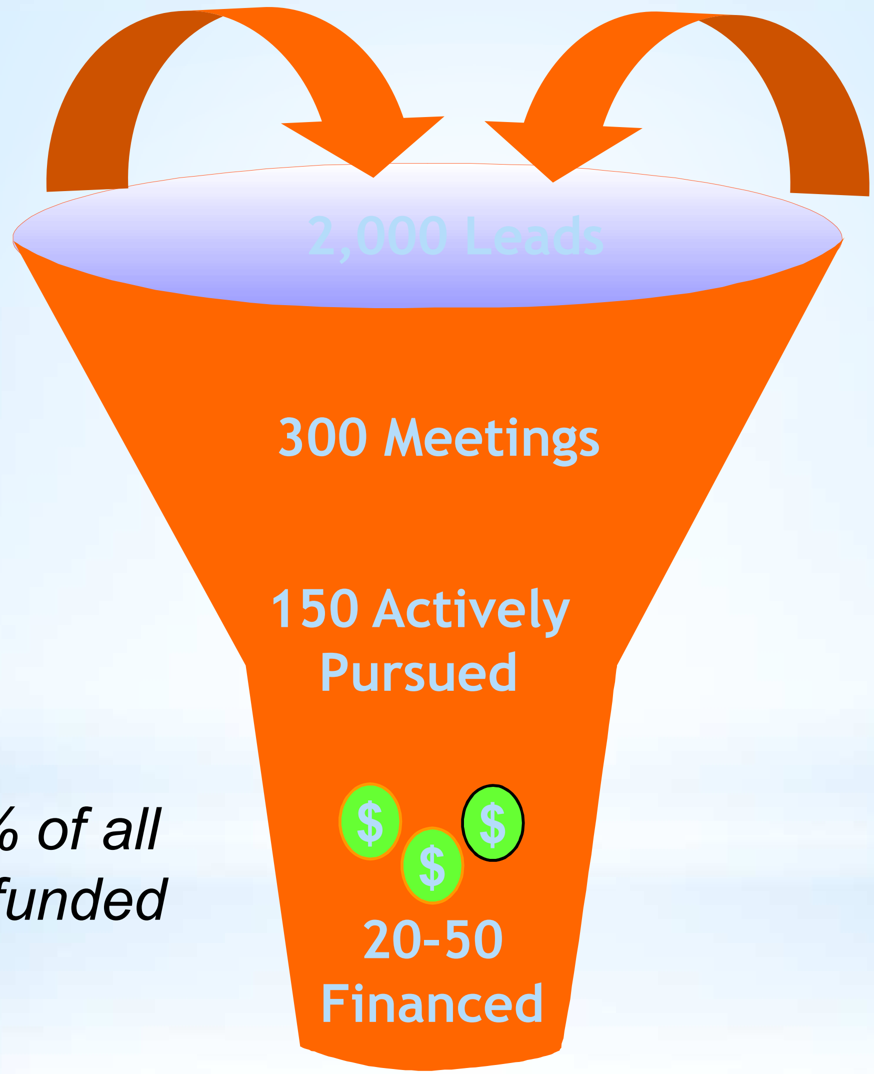
Liquidity to VC Shareholders

ROI

Some Good News:
The Cost To Start A Company 1995 To Present

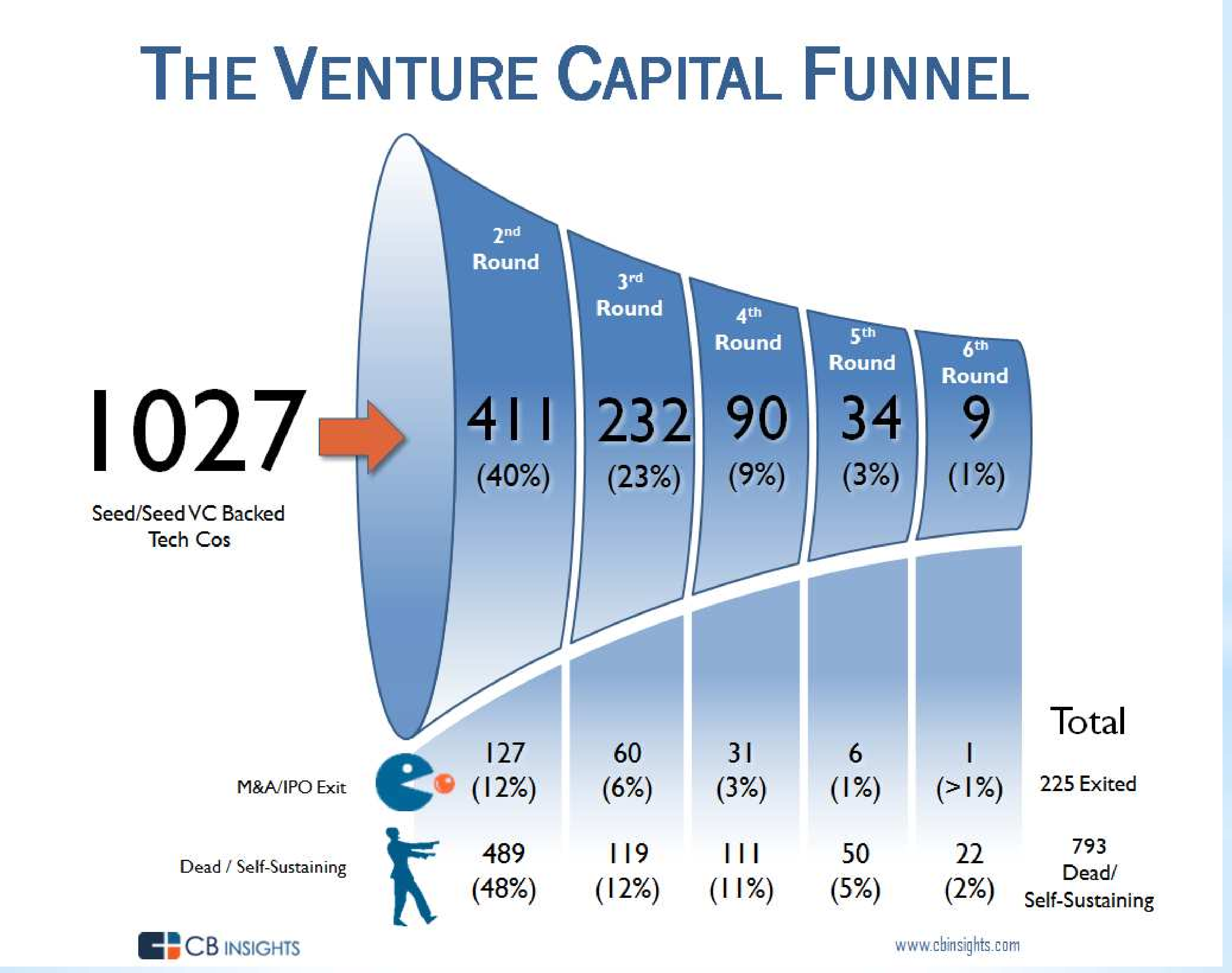


And the Bad News: The VC Financing—Getting Through The Funnel

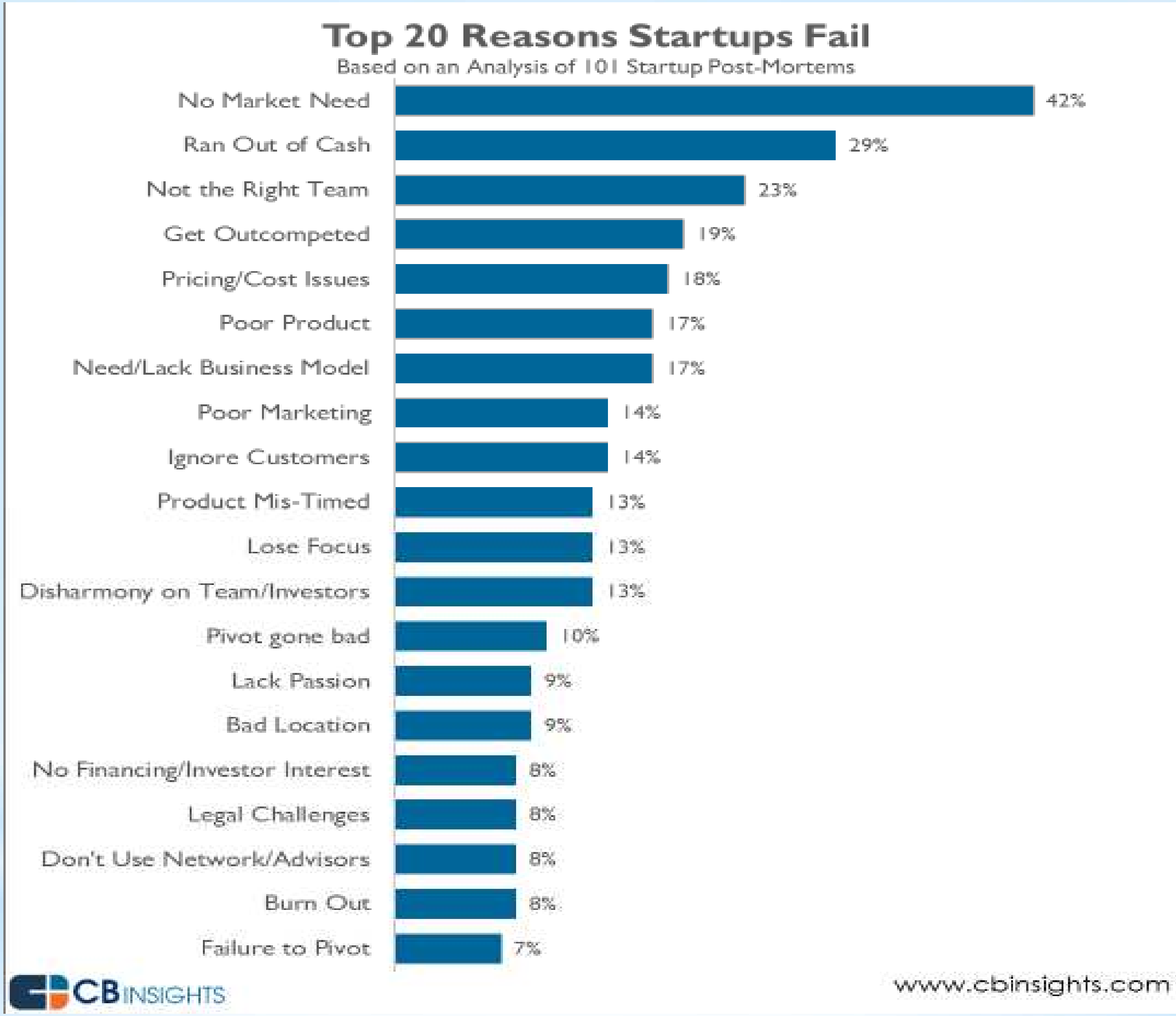


Only 1–2% of all leads get funded

<u>Source</u>: Goldman Sachs Merchant Banking



Source: CBInsights


Top 20 Reasons Startups Fail
Based on an Analysis of 101 Startup Post-Mortems
No Market Need
42%
Ran Out of Cash
29%
Not the Right Team
23%
Get Outcompeted
19%
Pricing/Cost Issues
18%
Poor Product
17%
Need/Lack Business Model
17%
Poor Marketing
14%
Ignore Customers
14%
Product Mis-Timed
13%
Lose Focus
13%
Disharmony on Team/Investors
13%
Pivot gone bad
10%
Lack Passion
9%
Bad Location
9%
No Financing/Investor Interest
8%
Legal Challenges
8%
Don't Use Network/Advisors
8%
Burn Out
8%
Failure to Pivot
7%
CB INSIGHTS
www.cbinsights.com

Fundraising

Financing Options for First Financing

Before:

Friends and family

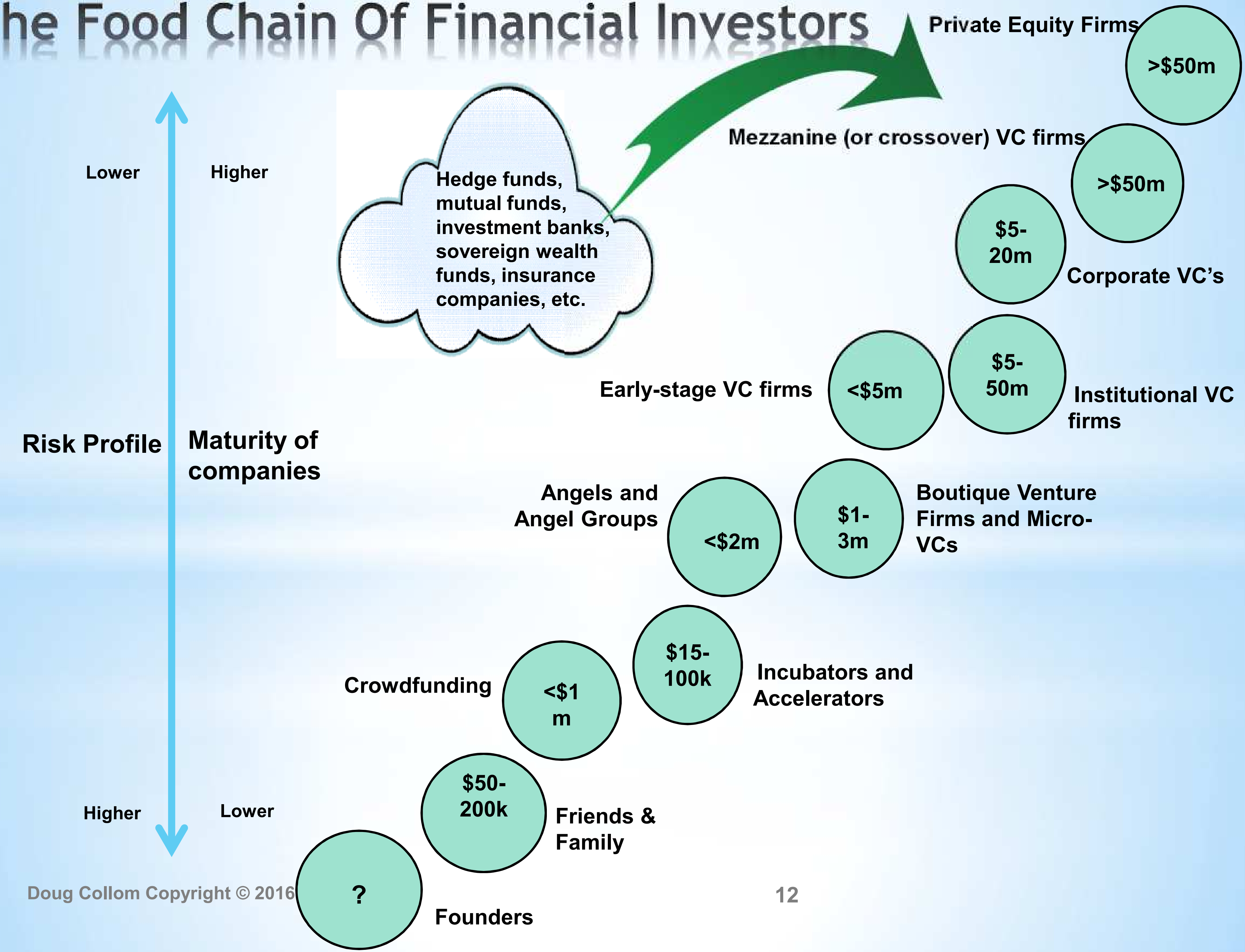
Angels

VC firm

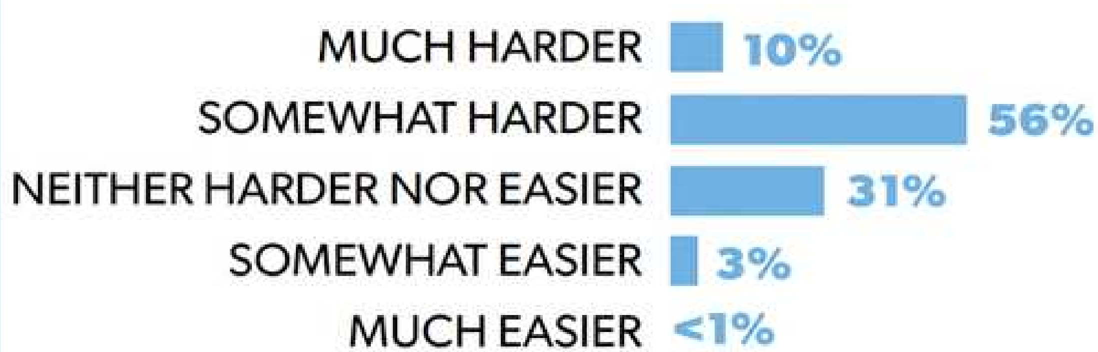
Now:

- Friends and family
- Angels
- Super Angels
- Micro VCs
- Incubators
- Accelerators
- Stage-agnostic VC firms
- Corporate investors
- Crowdfunding
- "Demo Day" pitch competitions
- Cross-over firms
- Investment banks
- Hedge funds, mutual funds
- Private equity firms
- Government business development centers

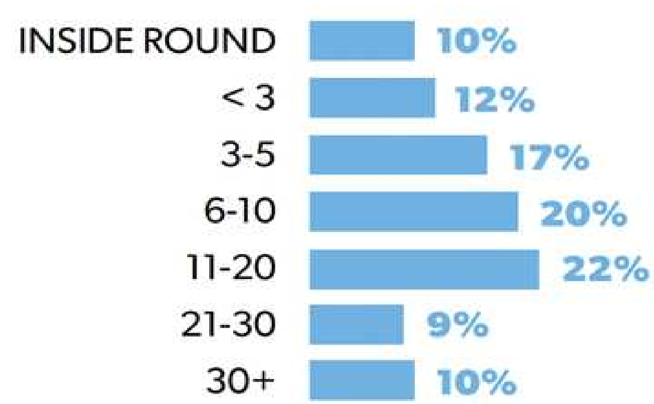
The Food Chain Of Financial Investors



Do you expect it to get harder or easier to raise venture capital in the next 12 months?



How many venture firms did you pitch when raising your last round of capital?



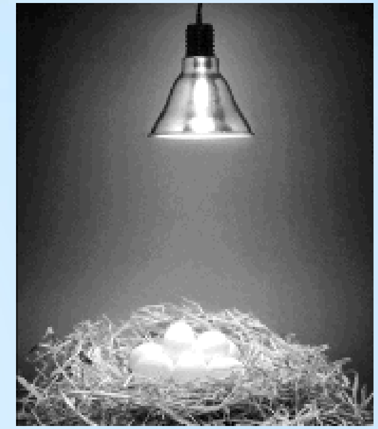
Source: First Round Review, December 2, 2015; survey of 500 CEOs

Sources of Early Capital:
Angels

* **Angel Groups**
  * Behave like institutional VCs in many dimensions (e.g. criteria for investment, operational and market diligence or marketing for deal flow)
  * However, angel groups have different organizational and governance structures and different investment philosophies
  * Examples:

* **"Super Angels" or "Micro VC's"**
  * Individuals who build funds with small groups of limited partners
  * Examples:

Sources of Early Capital:
Incubators and Accelerators



* There are hundreds of incubators/accelerators in the SF Bay Area alone; more than 2,000 in the United States

* Distinction
  * Incubators: Founders with an idea and a PPT. Most companies are at the planning, team-building and pre-funding stage
  * Accelerators: Companies that have some level of funding and some product development in motion

* Examples:

ROCK HEALTH

techstars

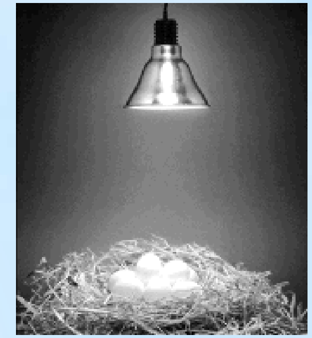
RocketSpace

Y Combinator

idealab

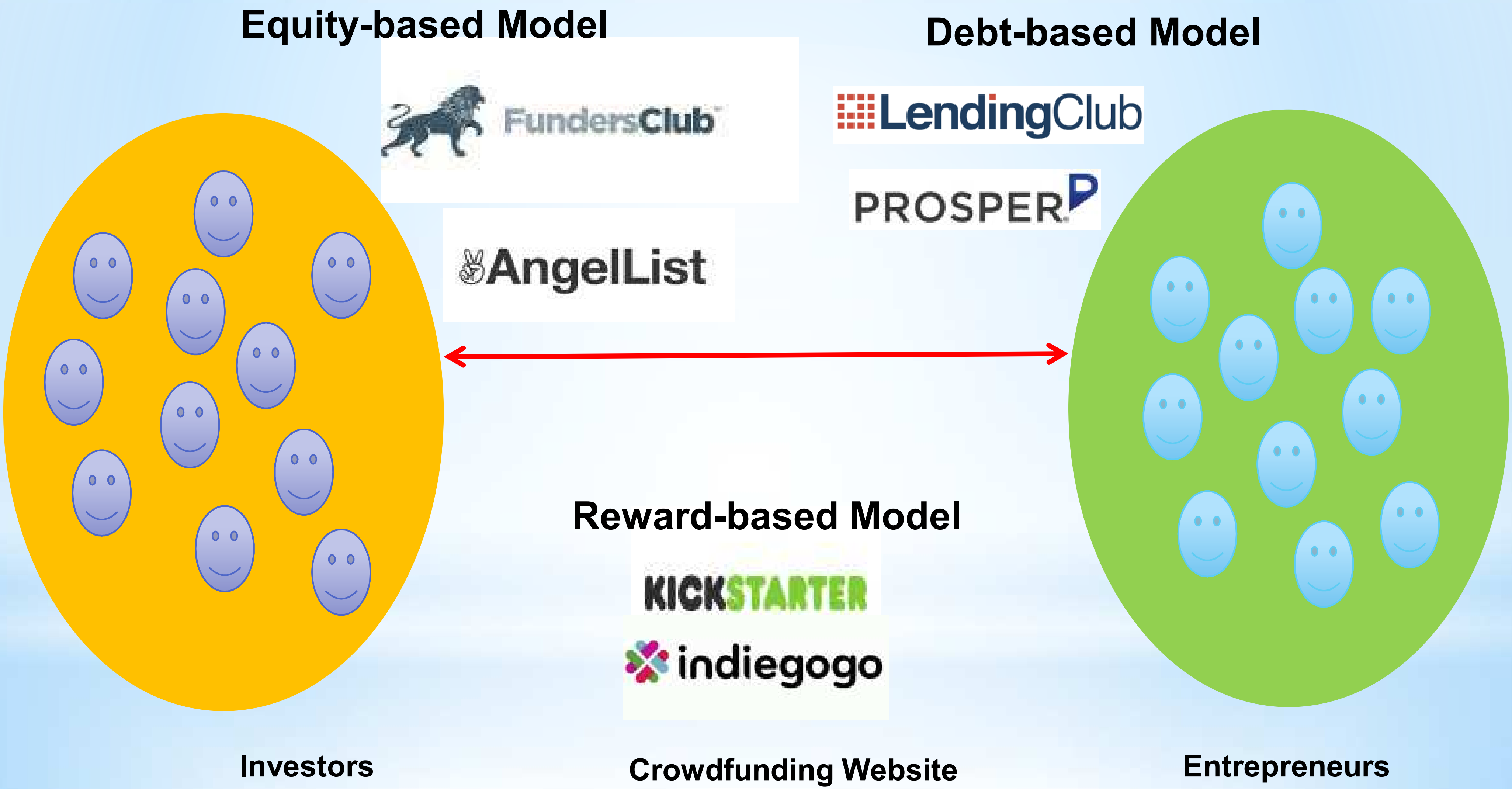
PLUGANDPLAY Silicon Valley in a Box

The Tradeoffs Of Using Incubators And Accelerators



What you get	What you give up
Space (desks, lights, office equipment, security)	"Real estate model" (rent): Usually tied to the amount of space taken up by the company.
Mentorship (coaching, speakers, panel events)	"Equity model": 2-10%, with the median in the 3-6% range (where equity is required at all). (e.g., YC wants 7% for $120K—with conditions)
Cohort environment (rubbing shoulders, sharing ideas with other founders)	Loyalty of employees: Employees may leave for greener pastures within the same incubator or accelerator
Access (programmers, co-founders, vendors, consultants, etc.)	Autonomy and performance requirements: Usually subject to progress requirements, growth constraints, time boundaries imposed by the incubator
Money: Sometimes seed money is given as an outright grant, other times it is structured as payment for equity	
Prestige: Tied to the prestige of the incubator, e.g., Y-Combinator, 500Startups, etc.	Loyalty of the incubator: Little diligence on participant companies; modest capital investment; no commitment for follow-on capital; little reason to keep startup in the incubator absent business traction.
VC introductions: Many incubators have partnerships with institutional VC firms (e.g., Y-Combinator and Sequoia Capital, SV Angel and DST Global)	

Sources of Early Capital
Crowdfunding



The Up- And Down-side Of Equity-based Crowdfunding

* Up-side
  * Cheap capital
  * Hypothesis testing and proof of concept
  * Marketing

* Down-side
  * Regulatory uncertainties
  * Know your investors?
  * Signaling to institutional investors?

AngelList

FundersClub

Pebble “Smart Watch”

Ouya Videogame Console

Evolution of the Financing Model for Early Stage Companies

Before:

Seed:
Angels only
$.2m-$1.5m raise
5-15% equity
Pre-$: $1.5m-$3m
Partial mgt team
Prototype or concept
No revenue

Series A:
VC's only
$5m-$10m raise
Pre-$: $5m-$8m
Core mgt team
MVP, beyond beta
First customers
Early revenue

Amount Raised — $0 — $5m — $10m

Today:

"Pre-seed":
Angels only
$100k-$500k raise
Co-founders
Prototype or concept

Seed:
VC's and select angels
$1m-$5m raise
15-20% equity
Pre-$: up to $5m
Core mgt team
MVP, beyond beta
Customers, revenue

Series A:
VC's only
$8m-$10m raise
25-40% equity
Pre-$: $10m-$15m
Core mgt team
Repeatable revenue
Growing customers

RAISING SEED MONEY

CONVERTIBLE NOTES OR SERIES A PREFERRED STOCK?

- **The founder's perspective — The benefits of a convertible note:**

Benefits
• Relatively easy documentation (15 pages of legal documents vs. 100 pages for equity financing)
• Faster to put in place (2 days vs. 2 weeks+)
• Sometimes only a single counsel is required to "represent" both sides
• Little negotiation required (convertible debt terms are mostly standard)
• Cheaper (legal fees < $10k vs. > $25k+)*
• No valuation required (nor other equity-type deal terms); except for the cap
• No impact on common stock pricing for employees/consultants

***Company always pays its own legal costs plus legal costs for investors' counsel.**

- Anecdotally, most seed financings (i.e., 80% or so where the seed is less than around $1m) are structured through the sale of convertible notes, not as preferred stock financings.

Fundraising: The Process

* What is the general process?
  * Introduction and initial contact with the VC
  * Initial due diligence by VC
  * A meeting with the VC
  * VC follow-up diligence: Contacts with consultants, customers, market research firms, etc.
  * Term sheet issued
  * 30-90 days of extensive DD
  * First Closing
* How long was your entire fundraising process for your most recent round?

Source: First Round Review,
December 2, 2015; survey of 500 CEOs

Importance of the Executive Summary

- Executive Summary
  - * Opening paragraph: The one-minute test
  - * Content: The ten minute test
  - * Not to exceed 2 pages! (better if 1 page)

- Must provoke immediate interest
  - * Currently unsolved industry problem
  - * Size of market
  - * Solution to problem
  - * Execution strategy
  - * Competition
  - * Financial projection
  - * Management team credentials

Valuation

How the game is played:

Sequoia Capital will provide you with **$4 million** in exchange for Series A Preferred stock.

How much is your company worth before the financing transaction (i.e., the pre-money valuation)? I.e., how much equity in your company do you have to give up to get the $4 million?

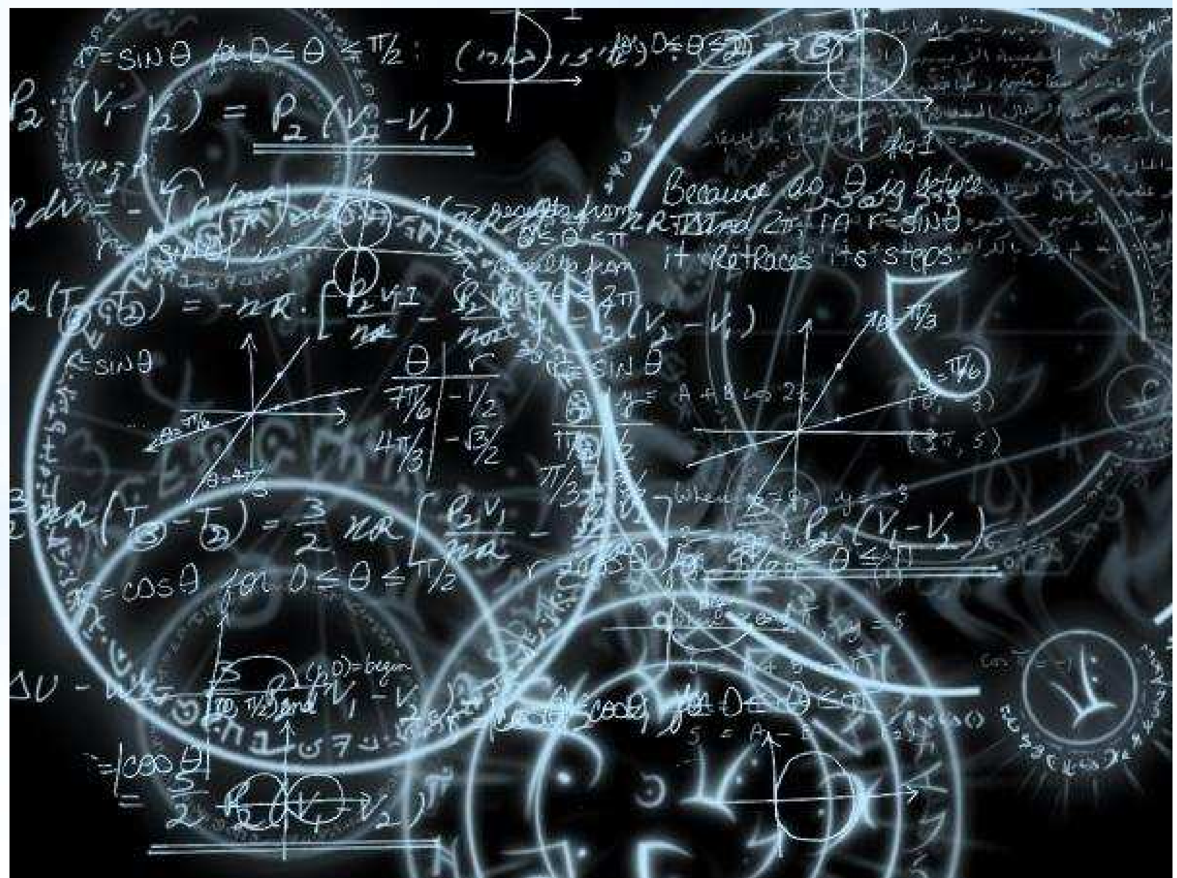
You think your company is worth $8 million in pre-money valuation.

Sequoia thinks $6 million.

Now what?

Valuation of Start-up Companies

* **Valuing Start-up Companies: Methodologies**
  * The Venture Capital Method
  * Comparable Company Method



Venture Capital Method

Visualization Of The Series A Financing

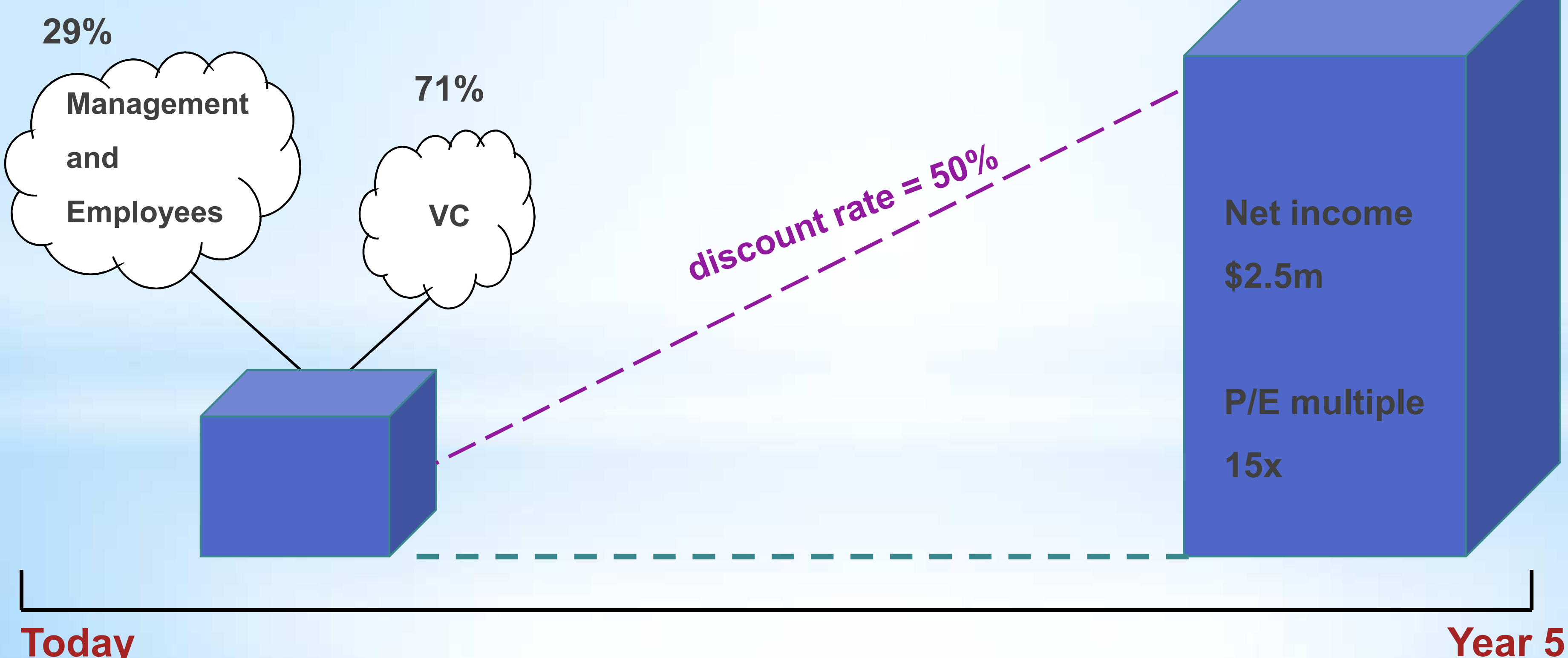
VC required IRR:	50%
Amount of investment:	$3.5m
Term of investment:	5 years
Projected net income:	$2.5m
P/E multiple:	15x
Outstanding shares:	1,000,000

= $26.6m required payback

Value in 5 Years

$2.5m x 15 =

$37.5m



Comparable Company Method

* Look for other firms with similar "value characteristics"
  * Risk
  * Growth rate
  * Capital structure
  * Size and timing of cash flows

* Select an appropriate comparable
  * P/E multiples
  * EBIT & EBITDA multiples
  * Revenue multiples
  * Book value multiples

* Databases
  * Crunchbase
  * CB Insights

VC Industry In The U.S Today

Median Pre-money Valuations By Round Class ($M) (Annual)

	2015	2014	2013	2012	2011	2010	2009	2008	2007
Later Stage	$400.0	$205.0	$95.6	$75.0	$67.9	$45.6	$38.5	$55.4	$44.4
Second Round	$57.1	$34.7	$23.6	$25.0	$19.5	$13.9	$17.7	$19.1	$17.9
First Round	$10.0	$8.5	$5.7	$7.2	$5.5	$5.5	$6.0	$6.1	$7.3
Seed Round	$3.6	$3.9	$2.0	$2.7	$2.8	$2.1	$2.1	$2.3	$2.0

Elemental Thoughts

Will You Be My Co-Founder?

- “Co-Founder” or “Early Employee”
  - Qualities: What does it take to be a co-founder?
  - Differences in roles and capabilities
  - Present vs. future capabilities: Scaling with growth

- Composition and size of the founding team

- Who cares? What’s the difference between a co-founder and an early employee?

Stock Ownership By Employees

- A very general rule of thumb for **non-founder** employees in a "mid-stage" technology start-up (i.e., post-Series A)

Position	No. of Ees	% of Capital	Aggregate Equity
* CEO	(1):	5-10%	7%
* CFO	(1):	1 - 2%	1%
* VPs	(3):	1 - 3%	8%
* Director-level	(6):	<1/2%	3%
* Others	(?):	<1/4%	6%
		Total	25%

Entity Selection: Delaware Subchapter C Corporation

* **You have a choice: general partnership, limited partnership, limited liability corporation, benefit corporation, Subchapter S corporation, Subchapter C corporation**
* **From an Entrepreneur's Perspective**
  * Both an LLC and a Subchapter S corporation can be used when (i) the entity will have very few owners in the first phase; (ii) the company will generate operating losses; and (iii) the owners uniformly want tax benefits associated with the losses
* **From a VC's Perspective**
  * **VC firms will rarely invest in an LLC!**
  * VC firms by definition cannot invest in a Subchapter S corporation
* **VC-backed companies are almost invariably (98% of the time?) Subchapter C corporations**
  * Mainstream practice is to incorporate in Delaware as a Sub C at the start

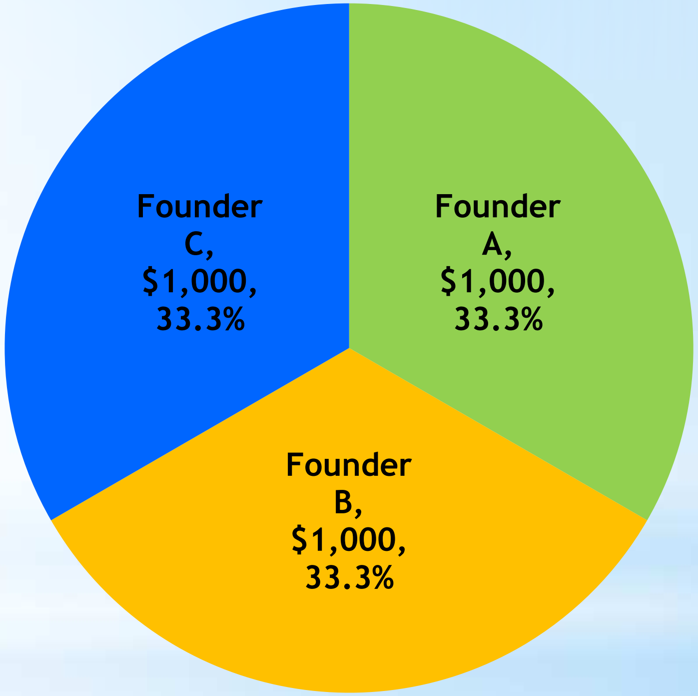
The Standard Capital Structure

- Common stock is typically used for compensatory purposes (i.e., employees, consultants, board members, etc.)
- Preferred stock is typically set aside as the vehicle for investment

The Evolving Capital Structure

- **I. Formation of a Start-up Company**

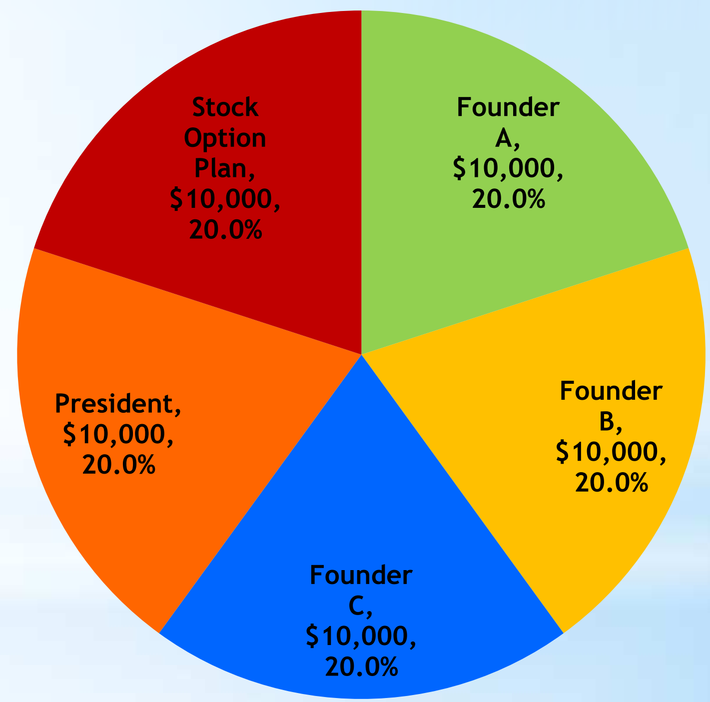
Person	No. of Shares	% of Shares	Value
Founder A	1,000,000	33.33%	$1,000
Founder B	1,000,000	33.33%	$1,000
Founder C	1,000,000	33.33%	$1,000
Total Post-Financing Valuation	3,000,000	100.0%	$3,000



The Evolving Capital Structure

- **II. Hiring of Chief Executive Officer & Establishment of Option Plan**
  - Reason for Dilution: Stock incentive provision.
  - Price (Pre-financing Valuation): $0.01/share ($30,000)

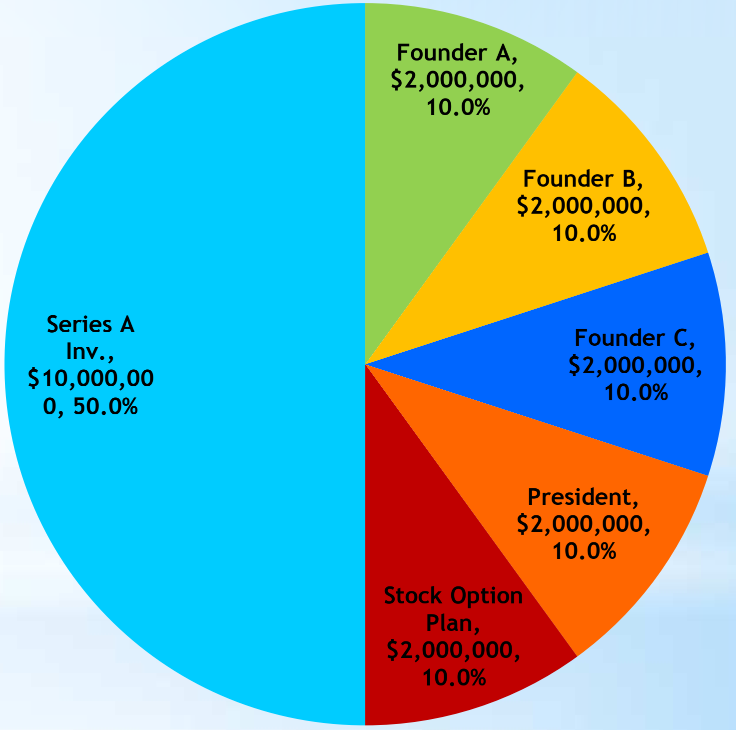
Person	No. of Shares	% of Shares	Value
Founder A	1,000,000	20.0%	$10,000
Founder B	1,000,000	20.0%	$10,000
Founder C	1,000,000	20.0%	$10,000
President	1,000,000	20.0%	$10,000
Stock Opt. Plan	1,000,000	20.0%	$10,000
Total Post-Financing Valuation	5,000,000	100.0%	$50,000



The Evolving Capital Structure

- **III. Initial Venture Financing Round**
  - Reason for Dilution: First round fundraising for product development.
  - Price (Pre-financing Valuation): $2.00/share ($10,000,000)

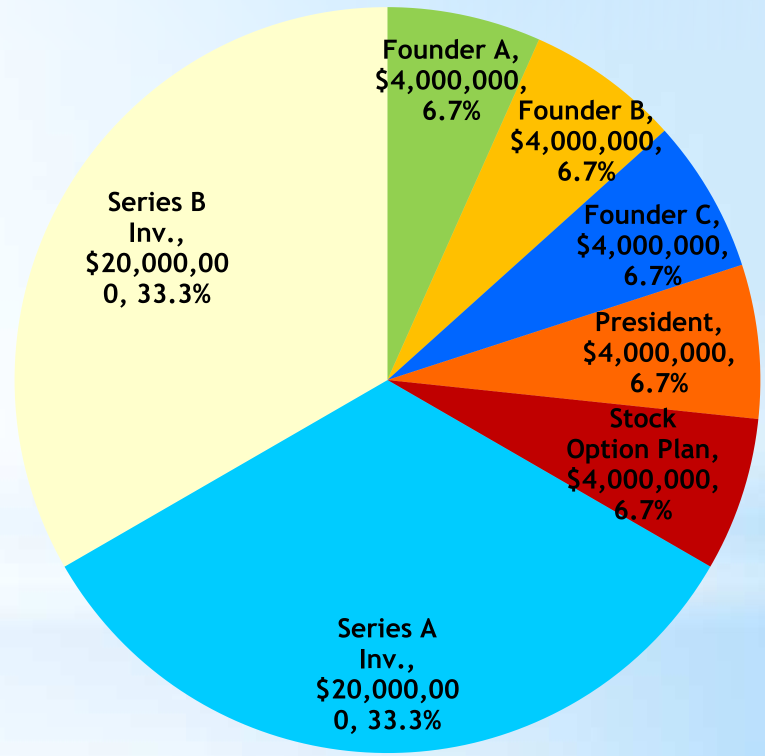
Person	No. of Shares	% of Shares	Value
Founder A	1,000,000	10.0%	$2,000,000
Founder B	1,000,000	10.0%	$2,000,000
Founder C	1,000,000	10.0%	$2,000,000
President	1,000,000	10.0%	$2,000,000
Stock Opt. Plan	1,000,000	10.0%	$2,000,000
Series A Investor	5,000,000	50.0%	$10,000,000
Total Post-Financing Valuation	10,000,000	100.0%	$20,000,000



The Evolving Capital Structure

- **IV. Series B Preferred Stock Financing**
  - Reason for Dilution: Second round fundraising for product development.
  - Price (Pre-financing Valuation): $4.00/share ($40,000,000)

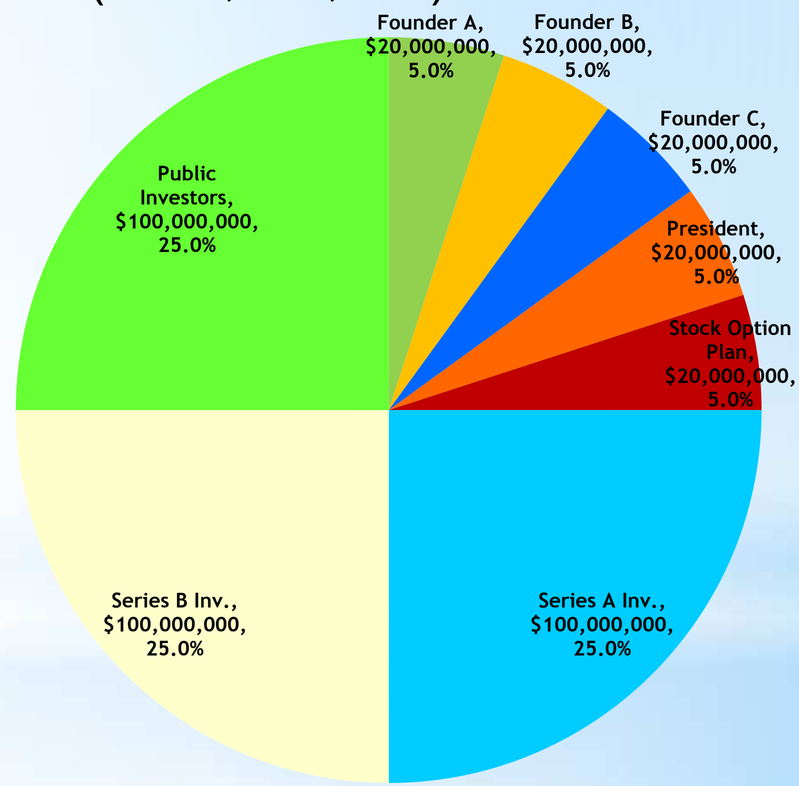
Person	No. of Shares	% of Shares	Value
Founder A	1,000,000	6.66%	$4,000,000
Founder B	1,000,000	6.66%	$4,000,000
Founder C	1,000,000	6.66%	$4,000,000
President	1,000,000	6.66%	$4,000,000
Stock Opt. Plan	1,000,000	6.66%	$4,000,000
Series A Investor	5,000,000	33.33%	$20,000,000
Series B Investor	5,000,000	33.33%	$20,000,000
Total Post-Financing Valuation	15,000,000	100.0%	$60,000,000



The Evolving Capital Structure

- **V. Initial Public Offering**
  - Reason for Dilution: IPO for expansion of manufacturing and marketing.
  - Price (Pre-financing Valuation): $20.00/share ($300,000,000)

Person	No. of Shares	% of Shares	Value
Founder A	1,000,000	5%	$20,000,000
Founder B	1,000,000	5%	$20,000,000
Founder C	1,000,000	5%	$20,000,000
President	1,000,000	5%	$20,000,000
Stock Opt. Plan	1,000,000	5%	$20,000,000
Series A Investor	5,000,000	25%	$100,000,000
Series B Investor	5,000,000	25%	$100,000,000
Public Investors	5,000,000	25%	$100,000,000
Total Post-Financing Valuation	20,000,000	100.0%	$400,000,000



Last thoughts:

Circulate

Educate

Triangulate