

Things You Need to Know When Starting a Company

Becky Voorheis

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Agenda

- Idea
- People
- Money

THE IDEA

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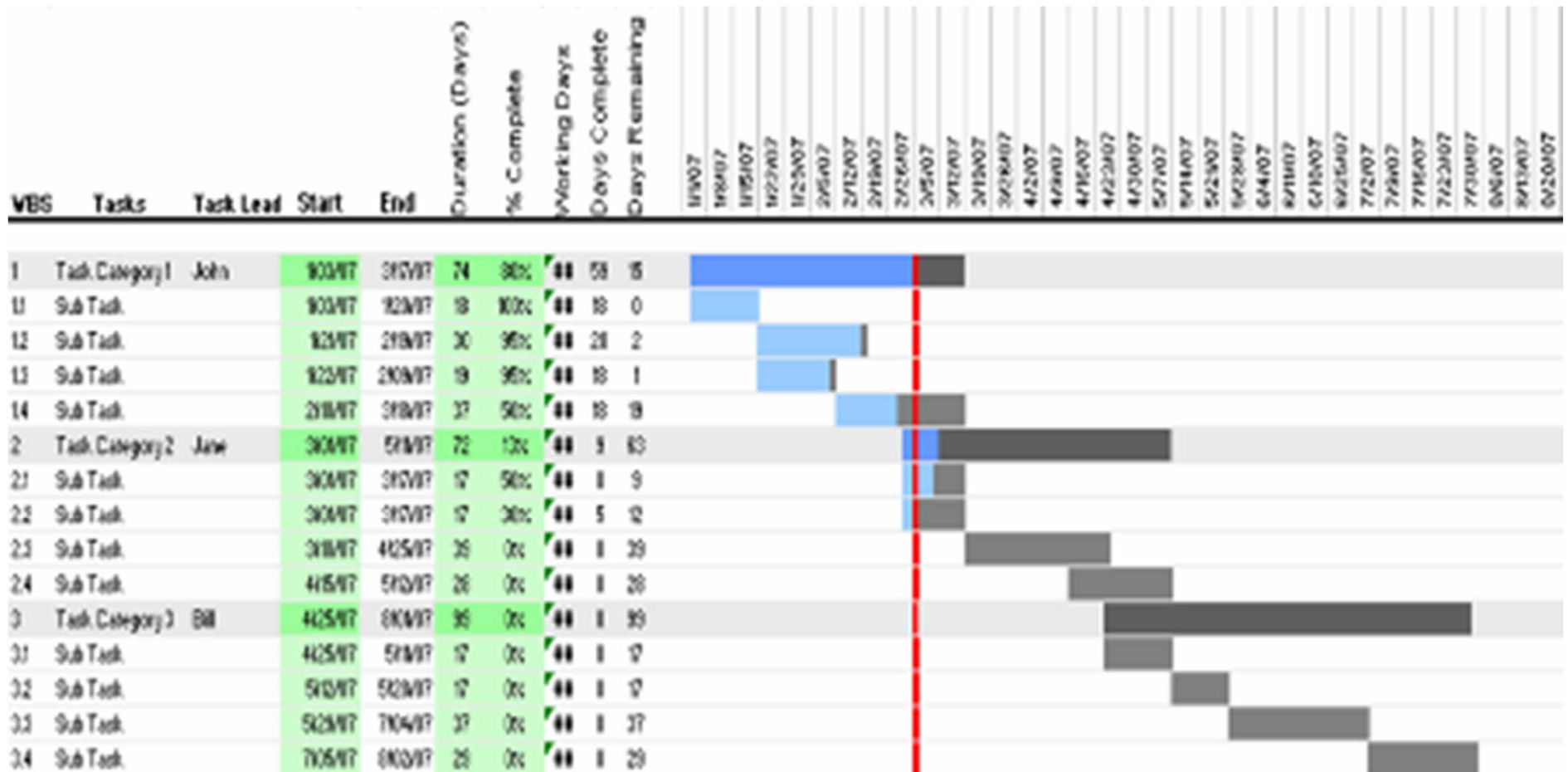
Write a Business Plan with YOU as the Audience

- Read it with a critical eye
 - Don't "drink the kool-aid" yet... there will be plenty of time for that later
- Does the business make sense to you? How well do you understand the market? Would *you* invest in it (because you will be)? Are you personally and professionally ready?
- Treat the plan as a living, breathing document
 - Not the final word

The Business Plan Should Answer 2 Major Questions

- 1. How much money will you make and how?
 - Size of the market, your projected share of that market, price/cost of the product, who will buy it and why, competitors, barriers to entry, etc.
 - What is the “exit”? Or is this a “lifestyle” company?
 - What are the most likely failure points and what, if anything, can be done to mitigate those risks?
- 2. How much time and money will it cost to get there?
 - Gantt chart the plan!

Gantt Chart



Add \$'s to the Bars – How Much Will Each Milestone Cost?

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Plan B

- What is it?
- Know when to stick to the plan – even in the face of adversity – and when to change the plan to accommodate reality
- When do you call it quits?
 - For too many, the answer to this question is “when there’s no more money”

THE PEOPLE

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Who is on the Bus With You?

- Who are the founders? (vision)
- Who else, if anyone, is on the team? (execution)
- How well do you really know them?
 - Plan for the worst, no matter how much you trust your partners
- What are everyone's respective motivations (power, money, prestige, independence, cocktail party conversation, etc.)?
- Don't forget advisors!
 - Great source of connections, expertise – often for little or no money

Define Roles & Responsibilities

- Detail what each person is supposed to achieve and how that weaves into the overall vision
- What are the carrots-and-sticks for performance (or lack thereof)?
 - Set them upfront and make them incredibly transparent & quantifiable
 - Ex: CEO gets 1,000 shares representing 10% of the company on xx date, vesting over 4 years with 25% vesting on year 1 anniversary and remaining vesting monthly on a pro-rata basis thereafter. Upon achieving licensing agreements representing at least \$2M in revenue potential, in aggregate, with 3 customers before xx/xx/xxxx, CEO will receive an additional 250 shares. Any unvested shares are forfeited for either voluntary or involuntary termination.

Primates Love Hierarchy

- Stereotype of everyone being equal at start-ups
 - Truth is there is hierarchy, but much more merit-based than at the Fortune 500
 - Hierarchy \neq tyranny
 - Not knowing who is in charge is a recipe for disaster
- Who owns the *vision* for the company?
 - Vision, ethics, and behavior of the leader = the culture of the company
- Who makes the big decisions?
- Who can hire and fire?

THE MONEY

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Where Will it Come From?

External

- Friends & family
- Angel investors
- Venture capital
- Government
- Foundations
- Corporations

Internal

- Founders
- Early revenue
- Side businesses

At What Price?

Source

- Friends & family
- Angel investors
- Venture capital
- Corporations
- Government
- Foundations

ownership

“Price”

- Awkward Thanksgivings
- Herding cats
- *Control and valuation*
- Ownership over the product
- Irrational or irrelevant requests/ requirements
- Harder to change direction if necessary

What is a Term Sheet?

- A 5-15 page document summarizing
 - 1. Who is investing, how much, and at what valuation
 - 2. Terms under which the investment will be executed
- Not the actual transaction documents
- Doesn't guarantee the deal will go through (non-binding)
- Does make raising money from other parties easier
 - Herd mentality

Memorandum of Terms for the Private Placement of Series C Preferred Stock

This Term Sheet summarizes the principal terms of a proposed financing (the “Series C Financing”) of [REDACTED], Inc., a Delaware corporation (the “Company”). With the exception of the terms under the heading “Expenses”, this Term Sheet is for discussion purposes only and there is no obligation on the part of any negotiating party until a definitive stock purchase agreement is signed by all parties. The transactions contemplated by this Term Sheet are subject to the satisfactory completion of due diligence and the negotiation of mutually satisfactory legal agreements. It is expressly understood that any party may, at any time prior to execution of a definitive agreement, propose different terms from those summarized herein or unilaterally terminate all negotiations without any liability whatsoever to the other parties. This Term Sheet does not constitute either an offer to sell or an offer to purchase securities.

Non-binding

“At least...”

Amount to Be Raised:	At least \$15,000,000
Type of Security:	Series C Preferred Stock (“ <u>Series C Preferred</u> ”)
Pre-Money Valuation:	\$45,000,000
Total Shares to Be Sold:	Approximately 28,951,563 shares of Series C Preferred
Purchase Price:	\$0.8747 per share (the “ <u>Purchase Price</u> ”), which shall be calculated on a fully diluted basis (including (i) shares issuable upon exercise of outstanding options and warrants and (ii) shares available for issuance under authorized stock plans, including the increase in the number of authorized shares available for issuance under stock plans as provided below).
Investors:	[REDACTED] will invest [\$3,000,000] of the total proceeds, with the balance available to existing and other new investors acceptable to the Company and [REDACTED]. Holders of Series A Preferred Stock and Series B Preferred Stock (the “ <u>Existing Investors</u> ”) are expected to contribute [\$10,000,000]. All Series C Preferred purchasers collectively are the “ <u>Investors</u> ”.

Valuation calculated on a fully-diluted basis!
(warning: stock overhang)

Investor who wrote this term sheet is in for \$3M – company needs to find at least \$12M more!

Existing investors have to pony up!

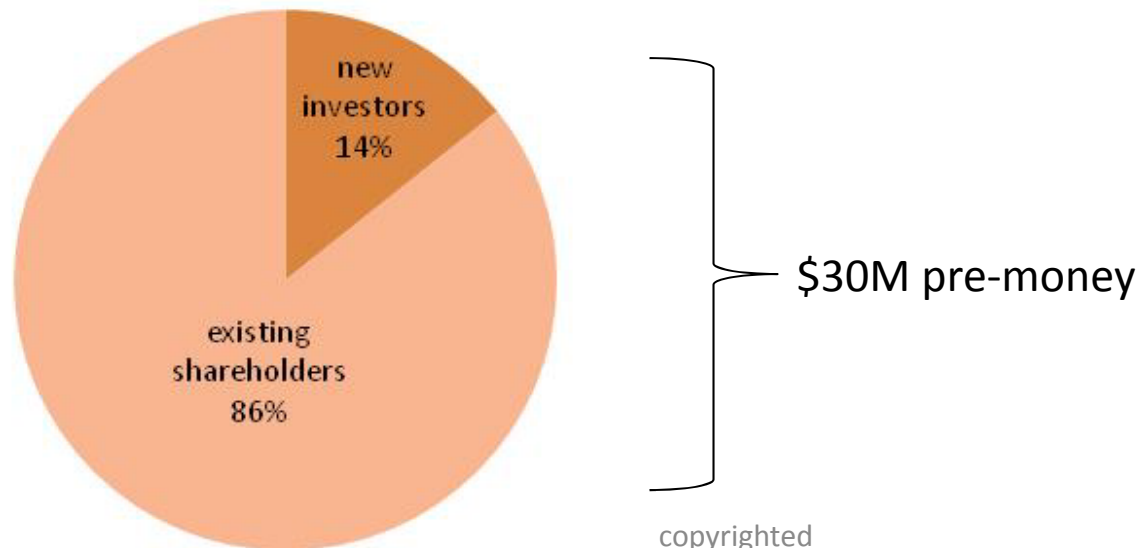
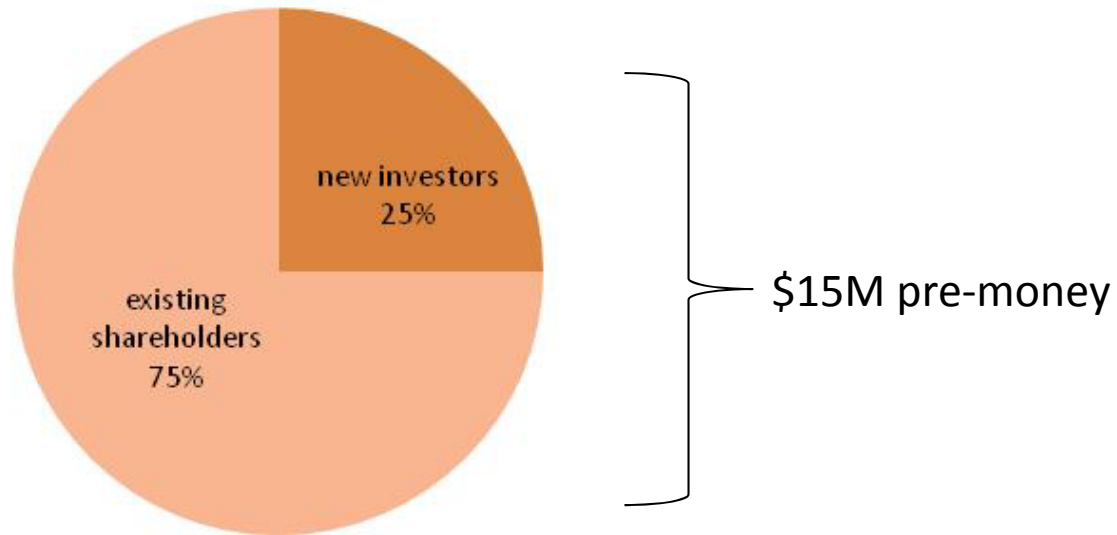
5. Post-Financing Capitalization: Capitalization section could be pre-money or post-money

Pre-money capitalization will include all outstanding shares of Common Stock and Prior Series Preferred (the existing Series A through E Preferred Stock), all outstanding warrants (including any to be issued between the signing of this term sheet and the closing), and all shares reserved for the stock option pool following the addition of shares sufficient to create an option pool equal to 15% of the Company's total post-closing capitalization. Immediately following the issuance of \$20 million worth of Series F, the capitalization will be set forth as follows, assuming no additional bridge financing or issuances of additional shares or warrants.

	<u>Amount of Investment</u>	<u>Shares</u>	<u>Ownership</u>
Existing Common Including Warrants		5,968,807	7.8%
Option Pool			
Existing Option Pool		5,099,896	6.7%
Addition to Option Pool		6,370,000	8.3%
Total Option Pool		11,469,896	15.0%
Total Common		17,438,703	22.8%
Prior Series Preferred Including Warrants		28,428,412	37.2%
Total Series F Preferred	\$ 20,000,000	30,578,077	40.0%
Total	copyrighted	76,445,192	100.0%

This investor is requiring a substantial increase in the option pool on a pre-money basis (i.e new investors don't take the dilution hit!)

Valuation & Dilution



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Share Price Calculation

- What you might think it is ...
(pre-money valuation)
(common stock + preferred stock)
- What it actually is ...
(pre-money valuation)
(common stock + pfd stock + all authorized options,
issued or not + all outstanding warrants + all
convertible debt)

Why Does This Matter?

	<u>Pre-Money Shares</u>	<u>%</u>	<u>Post-Money Shares</u>	<u>%</u>
Common Stock	9,937,411	19.3%	9,937,411	12.4%
Common Warrants	219,500	0.4%	219,500	0.3%
Common Options (Outstanding Grants)	1,483,556	2.9%	1,483,556	1.8%
Common Options (Available)	5,144,604	10.0%	5,144,604	6.4%
Series A Preferred Stock	17,834,674	34.7%	17,834,674	22.2%
Series A Warrants	215,981	0.4%	215,981	0.3%
Series B Preferred Stock	16,506,521	32.1%	16,506,521	20.5%
Series B Warrants	103,789	0.2%	103,789	0.1%
Series C Preferred Stock	-	0.0%	28,951,563	36.0%
Total	51,446,036	100.00%	80,397,599	100.00%

Pre-money valuation of this company was \$45M and the round was to raise \$15M

$\$45\text{M}/51.5 \text{ shares} = \$0.8738/\text{share}$

$\$15\text{M}/0.8738 = 17.2\text{M shares}$

= 21% of the company

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$\$45\text{M} / 45.8\text{M shares} = \$0.9825/\text{share}$

$\$15\text{M} / 0.9825 = 15.3\text{M shares}$

= 16% of the company

Takeaway: Watch the “equity overhang”! *By the way ... This is true for acquisitions as well.*

Back to the Term Sheet ...

- Can also name the board of directors and the use of proceeds

Rights & Privileges of the Investors

- Dividends
 - Investors almost never actually receive a dividend but this provision prevents common from receiving dividends
- Liquidation preference
 - Upon an exit, investors get some multiple of their money back before everyone else
 - If preferred stock holders would get more money if they held common shares, they have the right to convert to common
 - “Conversion right” (the above) can also be automatic, not voluntary
- Redemption
 - After [5] years, investors get their money back on a pro-rata basis if there has been no exit event

Rights & Privileges of the Investors

- Anti-dilution
 - Takes various forms of varying degrees of severity, but generally says that if in the future money is raised at a lower valuation than they are buying into, they get more shares to bring their average share price down
- Voting rights
 - Usually 1 vote per share, equal to common
 - Numerous voting thresholds will be established. Ex: 50% vote of the Preferred shareholders will convert everyone to common.
 - Voting classes will also be established. Do all preferred vote together as a class? Or do the separate series vote separately?
- Protective provisions
 - Blocks the company from doing certain things without the permission of the investors. Wide spectrum of severity from “can’t do anything that would take away our rights” to “can’t do anything at all” (basically)

Rights & Privileges of the Investors

- Right of first offer
 - Investors get to participate in future financings up to their current ownership percentage
 - In a seller's market, the company could make this a requirement or else preferred stock holders lose some/all rights
- Drag along rights
 - If [60%] of the preferred holders vote in favor of an acquisition, all stock holders must vote the same
- Co-sale and right of first refusal
 - Prevents investors and key management from selling shares until an exit event
- Information rights
 - Company has to report certain things to investors on a regular basis and has to permit inspection

Rights & Privileges of the Investors

- Covenants
 - Certain things the company either has to do or can't do “or else...” (Ex: have D&O insurance, have invention assignment agreements with all employees, etc.)
- Expiration
 - Term sheet is only good for a few days to a few months
- Expenses
 - Investors can require that the cost of doing the deal is paid for by the company (up to a cap)
- No Shop
 - Company cannot solicit, or even discuss, other offers until and unless the term sheet expires

THANK YOU!

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