

Angel and VC Funding Basics and Tricks

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Some great stories

Venture Capital Backed Companies Known for Innovative Technology

	Employees at IPO	Current Employees	Amount Invested	Current MV
Cisco	174	65,550	\$17 m	\$125 b
Intel Corporation	460	100,100	\$7.6 m	\$149 b
Medtronic, Inc.	1,287	45,000	\$0.2 m	\$60 b
Apple Inc.	1,015	63,300	\$9.7 m	\$555 b
Google	3,021	32,467	\$40 m	\$366 b

Source: IHS Global Insight, ThomsonOne 1/4/2013, various SEC filings

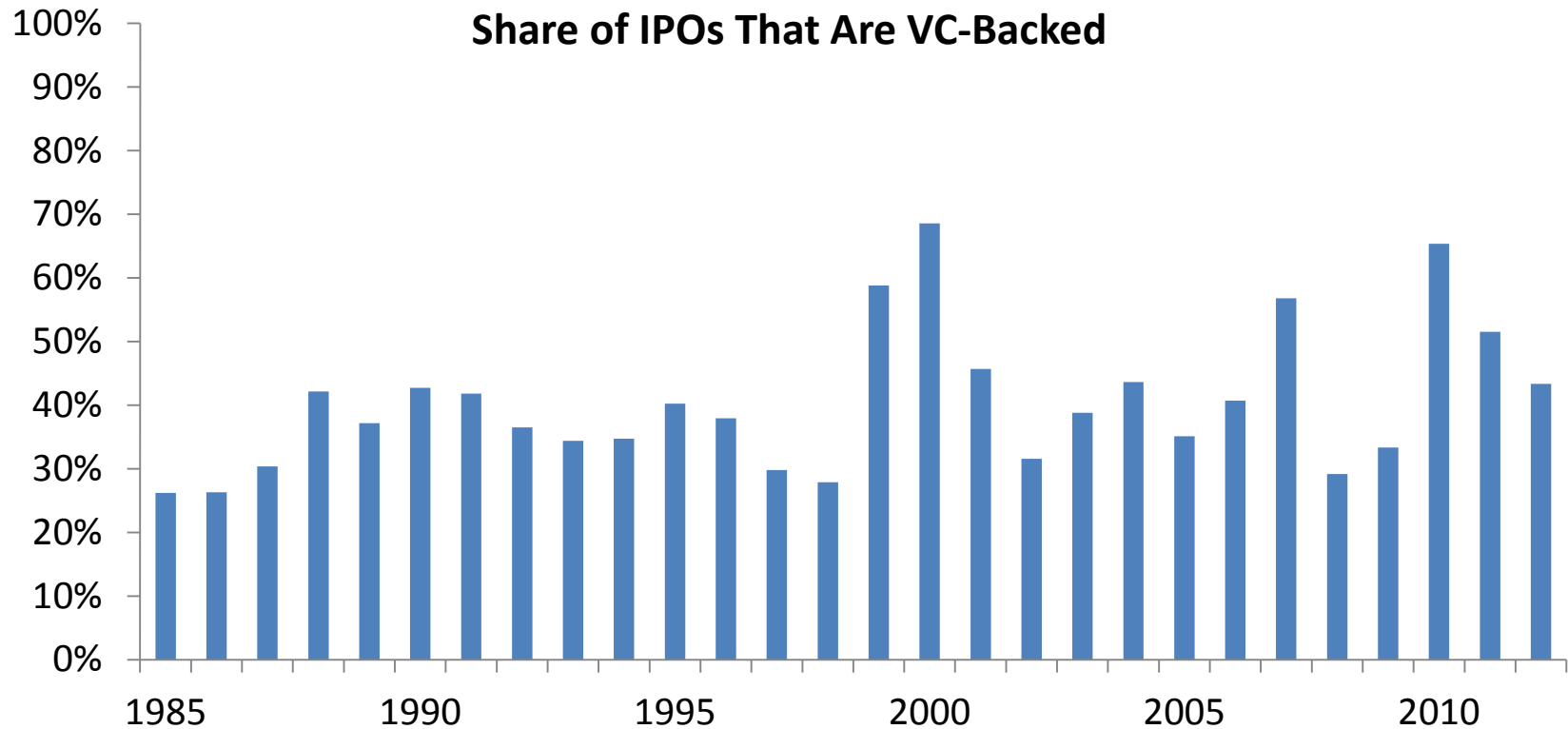
Some great stories

Venture Capital Backed Companies Known for Innovative Business Models

	Employees at IPO	Current Employees	Amount Invested	Current MV
Starbucks	2,521	149,000	\$13 m	\$56 b
Staples	1,693	89,019	\$34 m	\$7 b
Whole Foods Market	2,350	61,500	\$4.6 m	\$15 b
eBay	138	27,770	\$6.6 m	\$62 b
FedEx	2,444	278,600	\$25.8 m	\$41 b

Source: IHS Global Insight, ThomsonOne 1/4/2013, various SEC filings

VC-backed vs. non-VC backed IPOs in the US



Source: 2013 NVCA Yearbook Figure 4.02, Prof J Ritter IPO Data

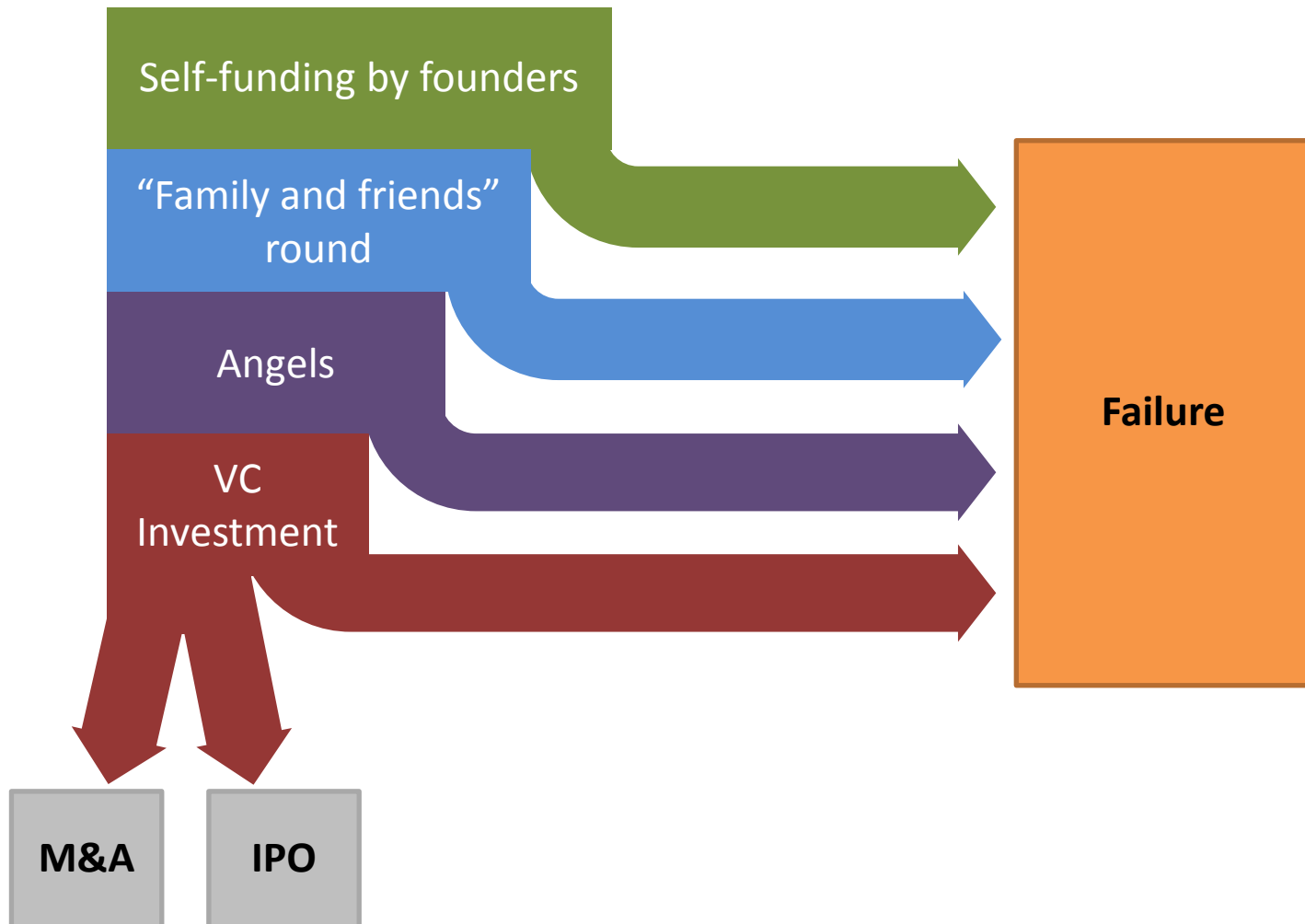
Ignite 2014

Funding

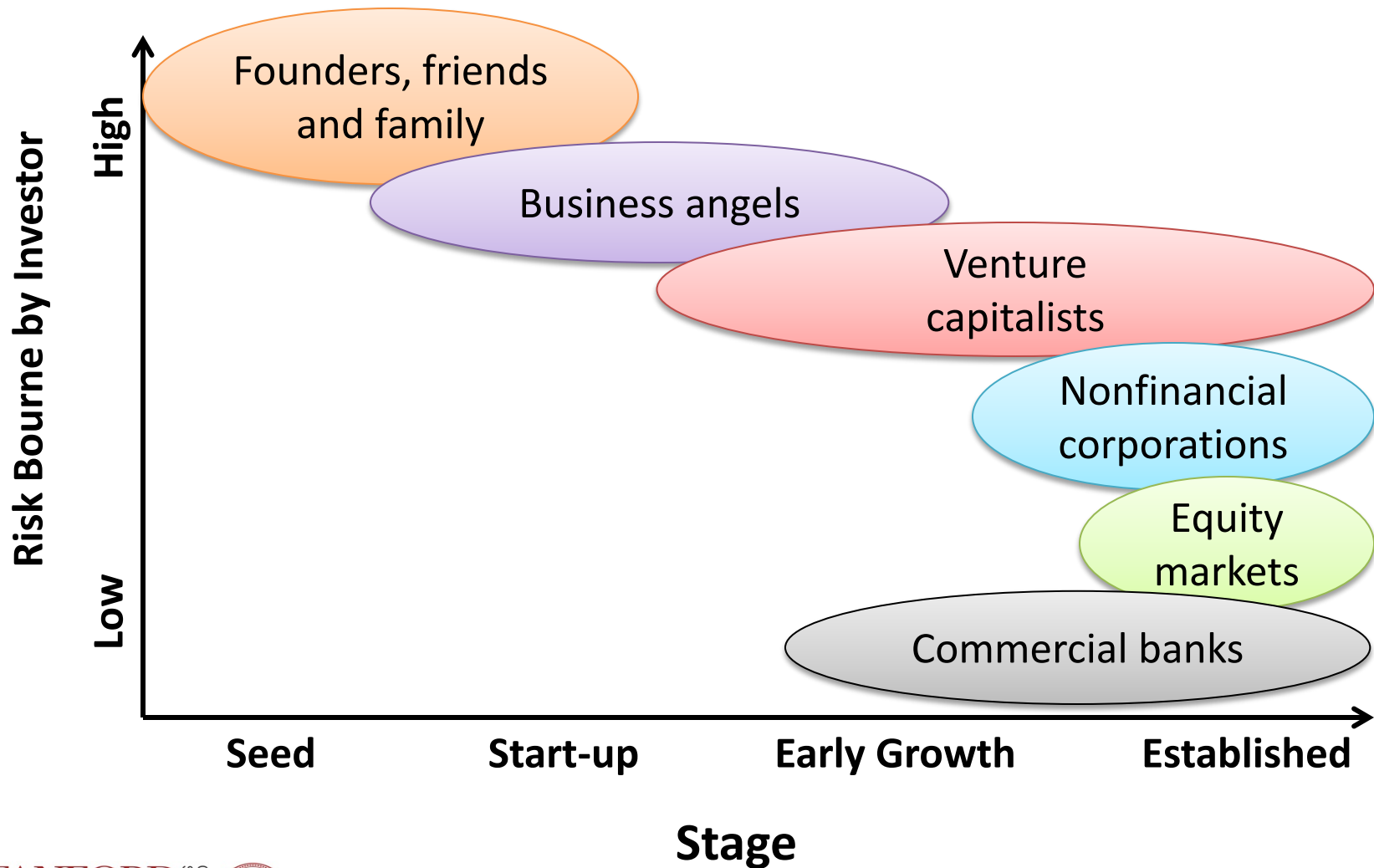
... And many failures



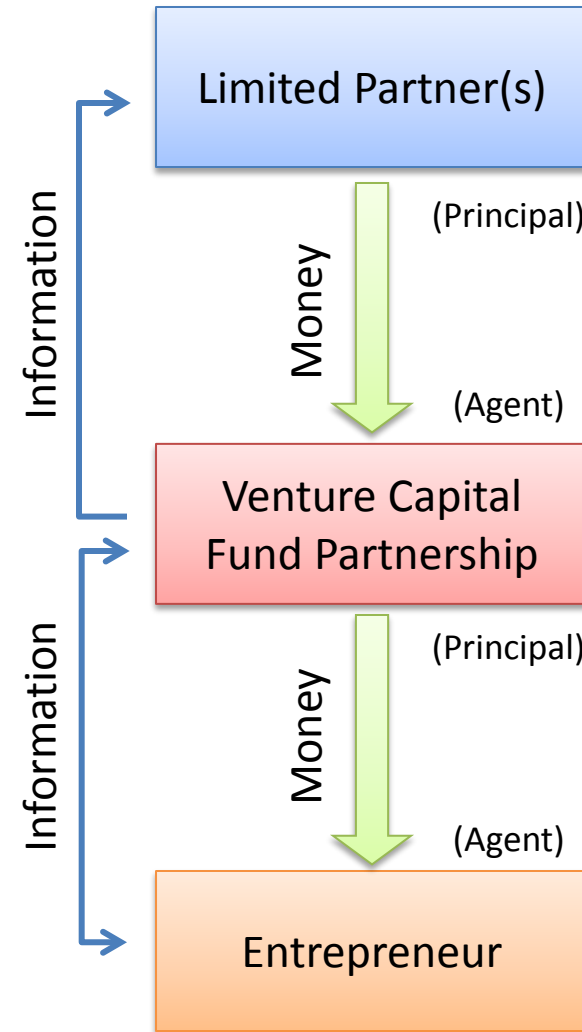
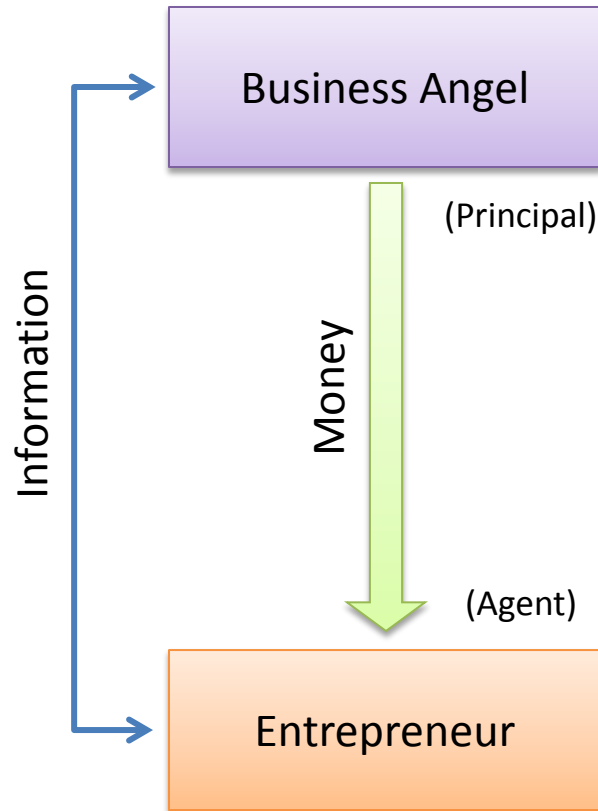
The Venture Capital Cycle:



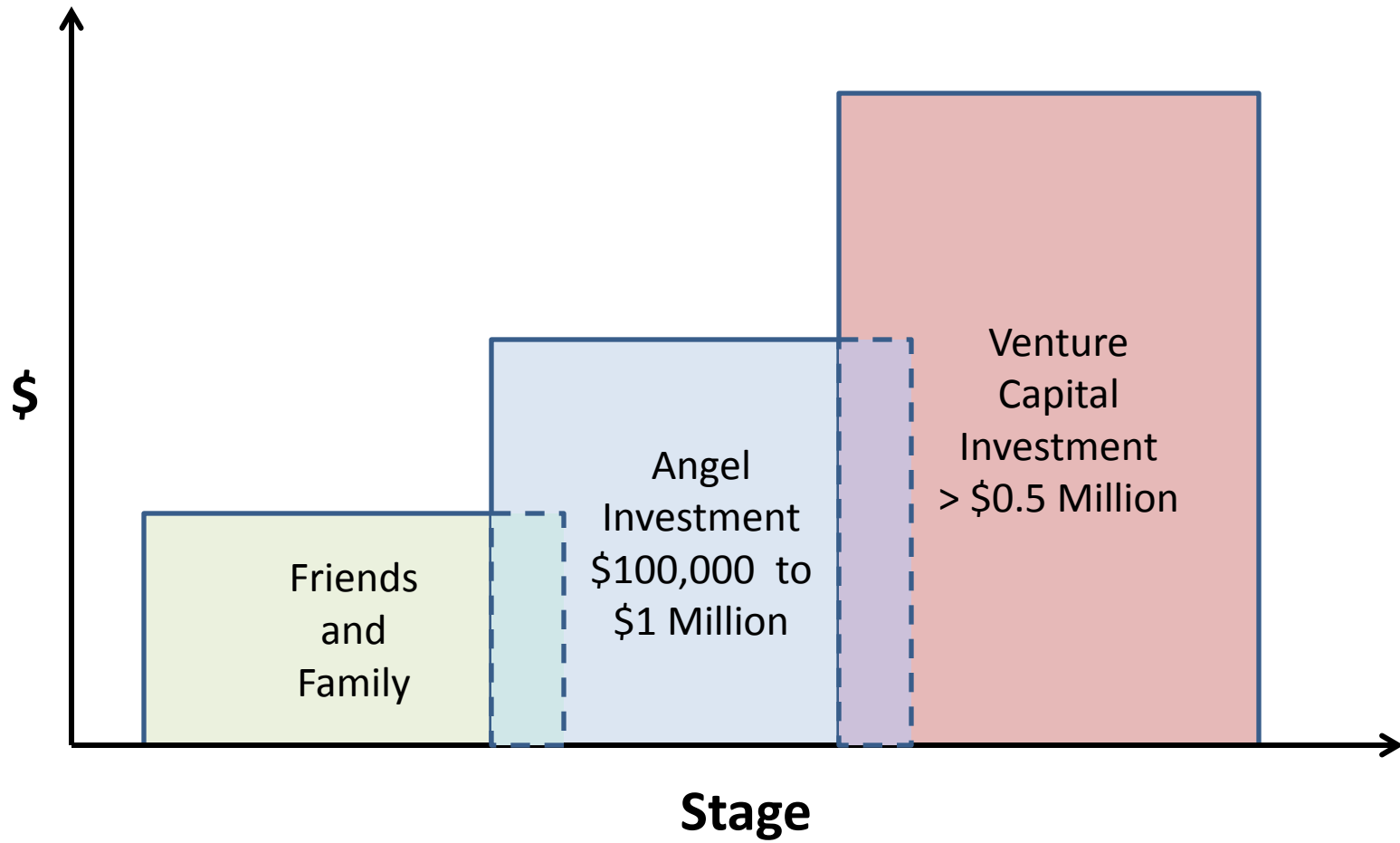
Angels vs. VCs vs. F&F



Angels vs. VCs



Angels vs. VCs vs. F&F



Role and importance of angels

- Size and timing of investment
 - Fill the niche between family & friends and VCs
- Risk-taking
 - Many are ready to take higher risks
- Timing of decision making
 - Angels typically act quicker than VCs
- Level of assessment and contracting
 - More informal
- Non-financial contribution
 - Advice, expertise, network of contacts
- Competition
 - Fill the funding gap unlikely to be provided by VCs

Angels vs. VCs

- Angels typically have weaker control rights
- Only-angel deals: only (?) when capital requirements are low
- VCs are:
 - More actively involved in the firm
 - More likely to seat on the Board
 - Less patient than angels
 - More likely to face pressure from limited partners
- Profit-seeking
 - VCs have fiduciary duty to maximize returns
 - Angels may have non-financial expectations and thus are ready to accept lower returns

When to raise money from Angels vs VCs?

- Taking money from angels may be better
 - Very early stage
 - Low capital intensity, bootstrapping
 - Does not require substantial capital investment
 - Less money spent – easier to pivot
 - Market is more of a niche

Types of angel investors

- Individual angels
- Angel consortiums
 - E.g.: Sand Hill Angels, Band of Angels, Tech Coast Angels
- Superangels/ Seed angel funds
 - E.g.: Felicis Ventures, Floodgate
- Accelerators/incubators
 - E.g.: Tandem Entrepreneurs, TechStars, Y Combinator, Plug&Play

Comparing angel types

- Whose money do they invest?
 - Individuals, Angel consortiums: own
 - Superangels: own plus other people's
- Signaling
 - Investing by reputable, respectable angels sends a strong signal
 - True for the top tier of every angel type
- Goals
 - Individuals, Angel consortiums: non-financial goals are important
 - Sharing expertise, social networking
 - Superangels: financial goals are more important

Investment criteria used by angels

1. Founding team: personality, experience, survival in tough times, industry expertise
2. Market: potential size, growth
3. Competition
4. Exit strategy: how liquidity will be achieved, timing
5. Product development: market validation, customer engagement
6. Business model: paths to monetization

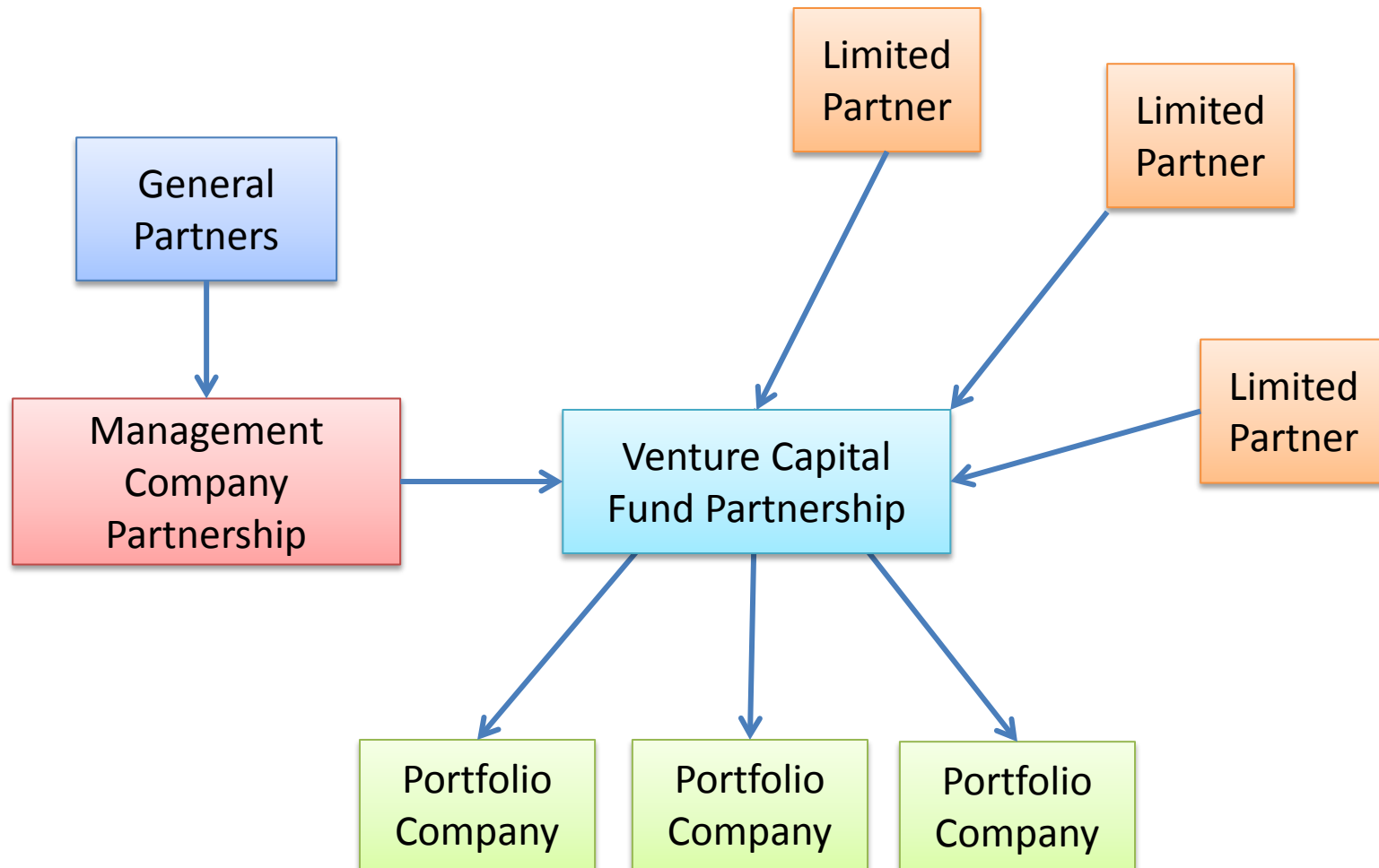
How is initial screening made?

- Initial stage: highest rejection rate
- Elimination-by-aspects
 - Shortcut decision making heuristic
 - Behavioral heuristic
 - Reduce available deals to manageable size
 - Trade-off: speed vs. accuracy
- “Fatal flaw” search
- Identification of critical factors
 - Diagnostic (correlated with success)
 - Objective (high correlations of ratings among many observers)
 - Speed (can be observed quickly)

How to attract angel investors?

- Have clear criteria whom do you seek
- Understand investors' motives and priorities
- Understand investors' investment criteria
- Understand investors' financial capacity
- Understand what investors most worry about
 - How they will get their money back
- Understand differences between different angel types
- Network and personal introduction are the best, find a lead angel investor

The VC process



What do VCs do?

- Investor
- Business owner
- Board member
- Recruiter
- Consultant
- Mentor
- Fundraiser

VC as an investor

1. Deal flow
2. Due diligence
3. Making investment decisions
4. Support of portfolio companies

Deal flow

- Seeking new investments
 - 20-40% of VC time
- In how many do they end up investing?
 - Less than 1 out of 100-300 pipeline deals end in investment
- Ways to generate deal flow
 - Networking
 - Identifying an emerging business sector
 - Identify each company in this sector
 - Visiting established companies with stimulated environments
 - Seeking people that may develop interesting ideas
 - Attending conferences and tradeshow
 - Teaching and coaching students
 - Keeping track of employees in VC-backed companies that exited

Due diligence

- Stages of due diligence
 - Quick assessment initially (screening)
 - Quick meeting (one associate/partner meets with the founders)
 - Detailed due diligence at later stages
 - Presentation to the full VC partnership
- Referrals
 - Source of referral
 - Degree of recommendation strength
- Company visits and meetings with the founders

Main questions that VCs ask in making new investments

- Do the founders have the gut to grow big or want a quick exit?
- Do the founders work well together as a team?
- Would I want to join this company?
- Am I prepared to work with the founders and be a board member for many years?
- How large is the potential market?
- Who is a potential buyer of the company?
- When can my fund exit this investment?

How VCs make decisions

- Frequent partner meetings
- Company presentations
- Decision-making modes
 - Consensus, unanimous vote, veto right
 - Voting process
 - Champion partner

Support of portfolio companies

- About half of VC partner's time
- Board membership
- Network contacts, advice, hiring help
- Follow-on financing
- Exit: Mergers, Acquisitions, and IPOs

The purpose of contracting

- Division of future payoffs
- Learning
 - VC about E
 - E about VC
- Resolving future agency conflicts
- Ex ante vs. Ex post views

Term Sheet

Exhibit 2
Term Sheet: Top Gun Venture Partners

TOP GUN VENTURE PARTNERS
SUMMARY OF PROPOSED TERMS & CONDITIONS
SERIES A PREFERRED STOCK

UNIVERSAL MOBILEAPPS, INC.

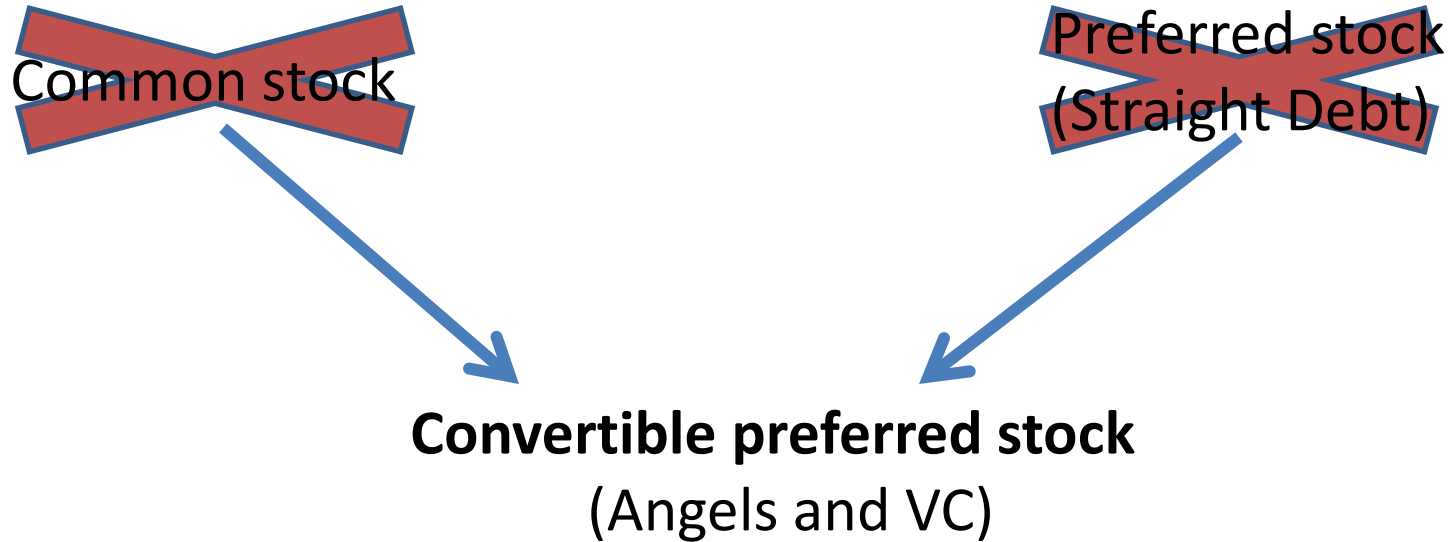
June 10, 2012

I. SUMMARY

<u>Issuer:</u>	Universal MobileApps, Inc. (the " <u>Company</u> ").
<u>Total Amount of Financing:</u>	\$4,000,000.
<u>Investors and Amounts:</u>	Top Gun Venture Partners (" <u>TGVP</u> ") 4,000,000
<u>Security:</u>	Series A Preferred Stock (" <u>Series A Preferred</u> ").
<u>Capital Structure:</u>	Based upon a \$9,000,000 post-money valuation.
<u>Option Pool:</u>	Post-closing the Company shall have a 25% pool available.
<u>Price Per Share:</u>	\$1.00 (" <u>Series A Original Issue Price</u> ")
<u>First Closing:</u>	Anticipated to be on or before May 25, 2012

II. TERMS OF THE SERIES A PREFERRED

- A. **Dividends:** The holders of the Series A Preferred will be entitled to receive non-cumulative dividends in preference to any dividends on Common Stock, but pari passu with the holders of Series A Preferred Stock and Series B Preferred Stock of the Company (together, the "**Existing Preferred**"), at the rate of 8% per annum when, as and if declared by the Company's Board of Directors ("**Board**").
- B. **Liquidation Preference:** In the event of any liquidation or winding up of the Company, the holders of Series A Preferred (the "**Preferred Stock**") will be entitled to receive, in



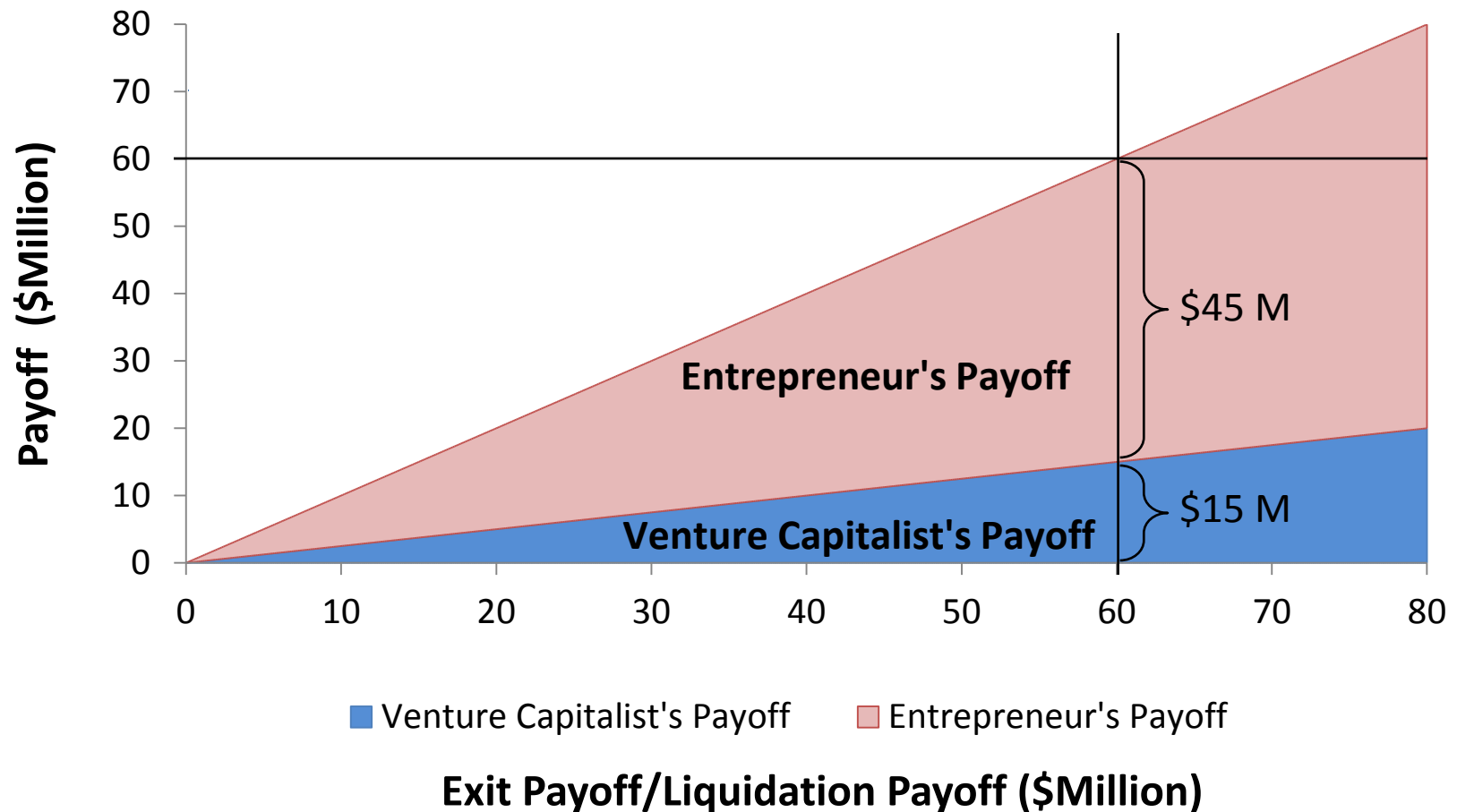
Common equity

- Example: E owns 7.5M shares. VC offers \$10M for 25% of the company
- **Amount raised:** \$10M
- **Capitalization:** capital structure before and after investment

	Pre-Money		Post-Money	
	# shares	%	# shares	%
E, Common	7,500,000	100%	7,500,000	75%
VC, Common	0	0	2,500,000	25%
Total	7,500,000	100%	10,000,000	100%

- **Price of one common share:** $\$10\text{M} / 2,500,000 = \$4$
- **Post-money valuation** of the company: $\$4 \times 10,000,000 = \$40\text{M}$
- **Pre-money valuation** of the company: $\$4 \times 7,500,000 = \$30\text{M}$

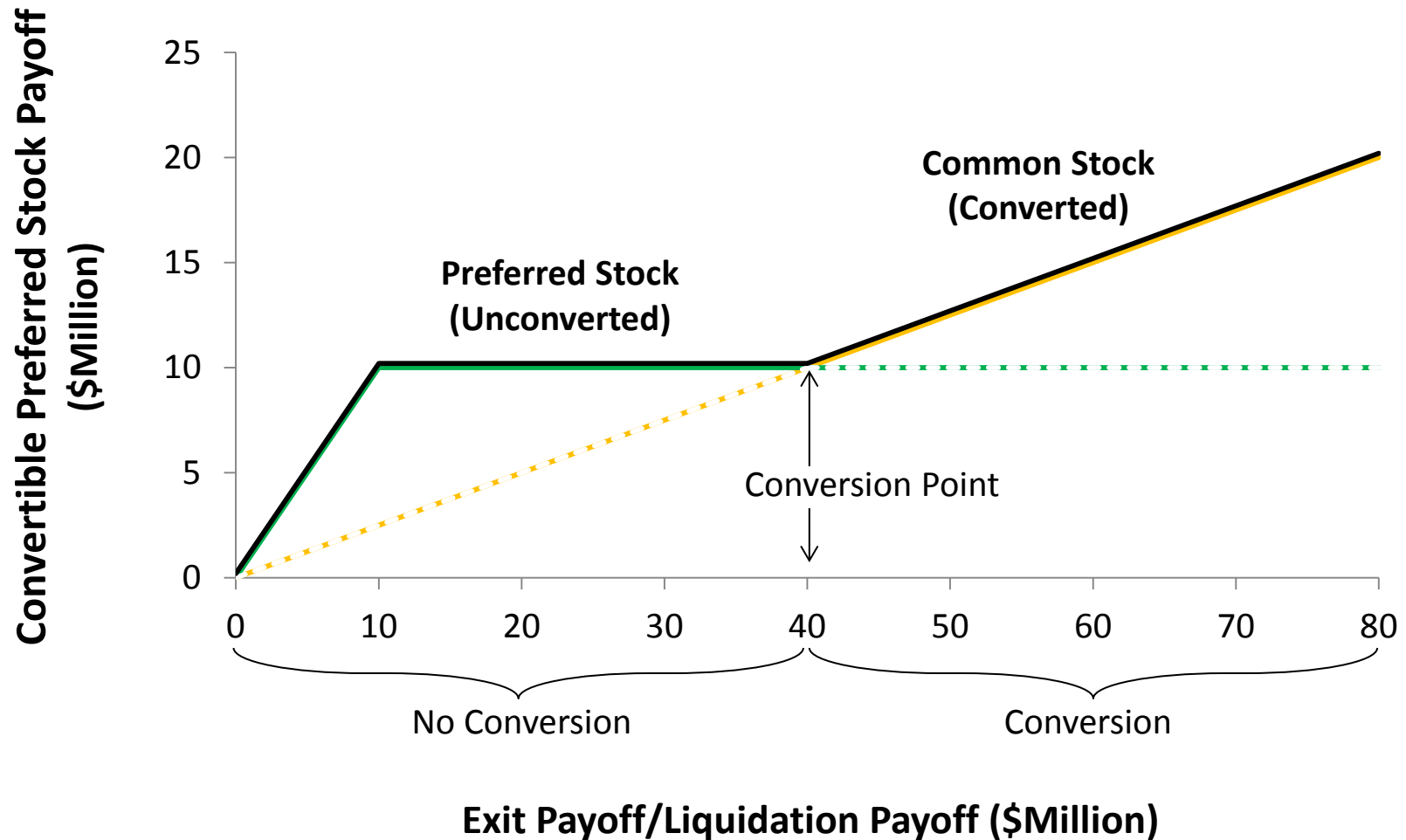
Illustration of equity payoffs



Convertible preferred stock

- Example: E owns 7.5M common shares
- VC offers \$10M of Series A convertible preferred for 25% of the company
- **Liquidation preference:**
 - Series A Preferred is paid first **one** times the original purchase price
 - The balance of any proceeds is distributed to Common Stock
- **Optional conversion:**
 - Series A Preferred converts **1:1** to Common Stock at any time at option of holder

Convert or do not convert? VC payoff



Corporate governance

- **Voting rights**

- Voting rights vs. cash flow rights

- Voting with Common Stock shares on an as-converted basis

- Increase or decrease of authorized Common Stock shares shall be approved by **majority** of Preferred and Common, voting together

- Majority** of Series A Preferred should consent to:

- Liquidation/exit
 - Amending By-Laws
 - Issuing any new securities
 - Paying any dividends
 - Changing the size of the Board of Directors

Corporate governance

- **Board composition**

- The Board shall consist of **five** members
- Series A Preferred elect **two** Board members
- Founders or their representative elect **two** Board members
- One** independent director, who is mutually acceptable to VC and E
- Each board committee will have at least **one** Series A Preferred nominee

Vesting and employee restrictions

- **Vesting:** Shares or options are earned over time
- **Step vesting:**
 - Typically occurs over three to five years at annual/quarterly/monthly increments
- **Cliff vesting:**
 - Vesting occurs at one time
- **Example:**
 - 30% after one year
 - Remaining 70% vesting quarterly over next four years

Vesting and employee restrictions

- Restrictions on founders and investors selling their shares
 - Transfer restrictions:** preventing sales of founders' stock without permission of investors
 - Tag-along rights:** the right of investors to participate in any of such sales
 - Right of first refusal:** investors can buy first at the price offered to other parties
 - Right of first offer:** Investors will be first to be offered shares
- **Non-competition, non-solicitation, and non-disclosure** for executive officers

Vesting and exit

- What happens to unvested portion in the liquidation event (IPO, acquisition)?
- **Single trigger**
 - Vesting is accelerated (full vesting)
- **Double trigger** (acquisition)
 - Vesting is accelerated if, in addition to an acquisition:
 - An employee is terminated without a case
 - Within specified period of time (often, one year)
 - Founders/employees can also be re-vested or vested with additional stock
- Complications of double-trigger/re-vesting
 - Re-vested in what? Acquirer's stock? What if the deal is in cash?

Economics of vesting

- Vesting is needed to align interests between Es and investors
- Ex ante vs. ex post
 - Getting a better vesting contract for the founders/first employees (e.g. single trigger) seems better for Es
 - Down the line, other key employees would prefer the same contract
 - Can affect acquirer's valuation / exit outcome