

FINANCING A STARTUP

PART 1: VC OVERVIEW OR “THE FUN STUFF”

PEPPERDINE LAW SCHOOL
ENTREPRENEURSHIP PRACTICUM

1Q17

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Please note that this presentation does not constitute legal advice.



STARTUP FINANCING OVERVIEW: TOPICS

1. The Venture Capital Industry
 - A Survey of Investors
 - Investment Types
2. The Venture Situation Now
 - Too much money at the wrong end
3. Startup Stages & VC Investment
 - *Matching money & milestones*

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PART 1. VC INDUSTRY TOC

- 1.1 A Quick Look at the Startup World
- 1.2 The VC Industry: Investor Types
 - The List of “Normal” Investors (that need legal assistance)
 - Other Options
- 1.3 VC Investors One-by-One



1.1 THE STARTUP WORLD: BY THE NUMBERS

Since 1999:

- 10x more people online
- US ecommerce and online ad revenues up by 15x
- software dev costs dropped by ~10x
- Pipeline speed up by 5-10x

Current funding:

- 2-4 out of 100 get any funding
- 15,000-20,000 startups funded by angels
- **1500-2000 VC funded per year**
- VCs analyze ~400 for each investment
- Decline from ~1200 to 800 VC funds (08-14)

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ON THE OTHER HAND . . .

Angel:

- 213 rounds (E&Y)
- 218 rounds (PwC)
- 101 (2006-2014 average: CrunchBase)

Venture:

- 3,267 “non-angel” rounds (E&Y)
- 3,777 (Early Stage, Expansion, and Later Stage: PwC)



1.2 THE VC INDUSTRY: INVESTOR TYPES

Angel investors

- Individuals/Networks

Accelerators

- Y Combinator, 500Startups, Techstars
- Foreign: Rockstars, LVentures, TAG

Venture Capital Funds

- Micro VC Funds
- Seed
- Early stage/”Bridge to A”
- Later stage
- Mega Funds
- Sidecar funds

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OTHER OPTIONS

Credit cards

- Personal risk

FFF

- Friends, families and fools

Banks

- Unsecured/secured lending

Crowdfunding

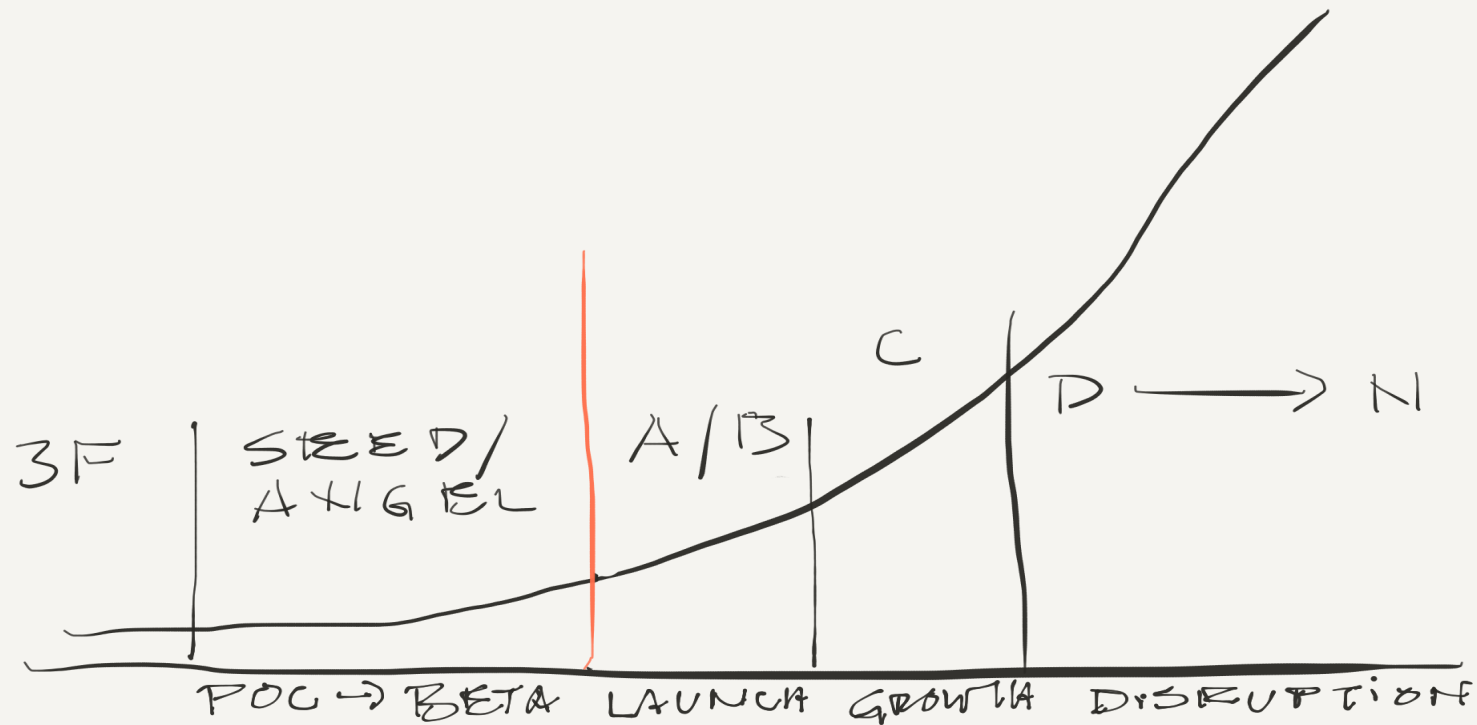
- JOBS Act, Flashfunders, et al.

Private Equity

- Final stages



MONEY BY GROWTH STAGE



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1.2 INVESTORS ONE-BY-ONE

All of them comply with federal law as
“accredited investors”



ACCELERATORS

Fixed-term, cohort-based programs, that include mentorship and educational components and culminate in a public pitch event or demo day.

-Wikipedia

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ACCELERATORS (CONT'D)

- 650-800 accelerators around the world as of 2016
- 20% CAGR
- 3 weeks-6 months
- Sometimes acquire ~5% of equity (common stock)
 - Might provide grants
- Higher percentage of follow-on VC funding

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ANGEL INVESTORS

Individuals:

- Wealthy individuals you find through personal contacts

Networks: Pasadena Angels

- Groups of wealthy individuals who join together to create processes for pitches and due diligence
 - Usually make individual investments

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WHAT IS ANGEL INVESTMENT?

First money in after:

- Founders (e.g., credit cards)
- FFF

Expecting sufficient traction to attract
VC Fund

Money usually for 6-9 months

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ANGEL INVESTMENTS

Professional investors invest in teams

- Good idea + *great* team always beats great idea + good team
 - Like people with a track record
- *But*, they accept that founders are not (necessarily) professionals
- More willing to fund “newbies”

What milestones will be achieved with my money?

- POC?
- They have improved enough to get the next round of money at a higher valuation

Range:

- \$50-150K (sometimes higher)

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ANGEL DEAL DOCUMENTS

Like all professional investors,
investment documents are now a
commodity

- Very little room for negotiation

Convertible note

- increasingly using SAFE Agreements

Investment Agreement

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WHAT IS A SEED ROUND?

“Half Step” to real money

- Often done by angel networks or seed funds (VC funds)

Small money:

- \$50K-500K

Purposes:

- early-stage operations—primarily POC and market research
- Validate viability

But does it “move the needle?”





Lean Startup Methodology

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SEED VC EXAMPLE

Our Investment Criteria

SECTORS	FUNDING	GEOGRAPHY	BUSINESS MODEL
 <p>Focus on enterprise software, commerce platforms and marketplaces but are open to exciting ideas in other verticals.</p>	 <p>Typical investments range from \$250,000 to \$2,000,000. Prefer co-investor roles and will participate in follow-on rounds.</p>	 <p>U.S.-based companies, preferably on the West Coast.</p>	 <p>Proof-of-concept in place (post-revenue or with secured contracts). Requiring less than \$5,000,000 and three years to reach break-even point.</p>

Display a menu



VENTURE CAPITAL FUNDS

- All US venture funds are limited partnerships
- All funds have a general partner and limited partners
 - Usually multi-billion dollar orgs., e.g., pension funds
 - LPs do *not* participate in managing the VC fund or the portfolio companies
- GP is usually an LLC (or equivalent)—or includes one

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VENTURE CAPITAL FUNDS (CONT'D)

- GPs have unlimited liability
- GPs are paid by annual management fee (1.5-2.5%) and “carried interest” (~20%)
- VC Funds (generally) do not pay for legal fees for portfolio investments*
- For “club deals” one VC will lead a deal
- Through 2008 (or 2012) VC ROI was disappointing--~muni bonds



MEGA-FUNDS

- Funds >\$500m
- 2016: 2014
 - Accel, Andreessen Horowitz, Battery Ventures, Founders Fund, General Catalyst, Greylock, Kleiner Perkins Caufied & Byers, Lightspeed Venture Partners, Norwest, Sapphire Ventures, Spark Capital, TCV, Thrive Capital
- Primarily long-established funds (1982)
- Minimum investments usually \$10m—often \$30-100m

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MEGA *MEGA* FUND

SoftBank Vision Fund

- \$100 *billion*
- \$100m minimum investment
- Calls itself a private equity fund



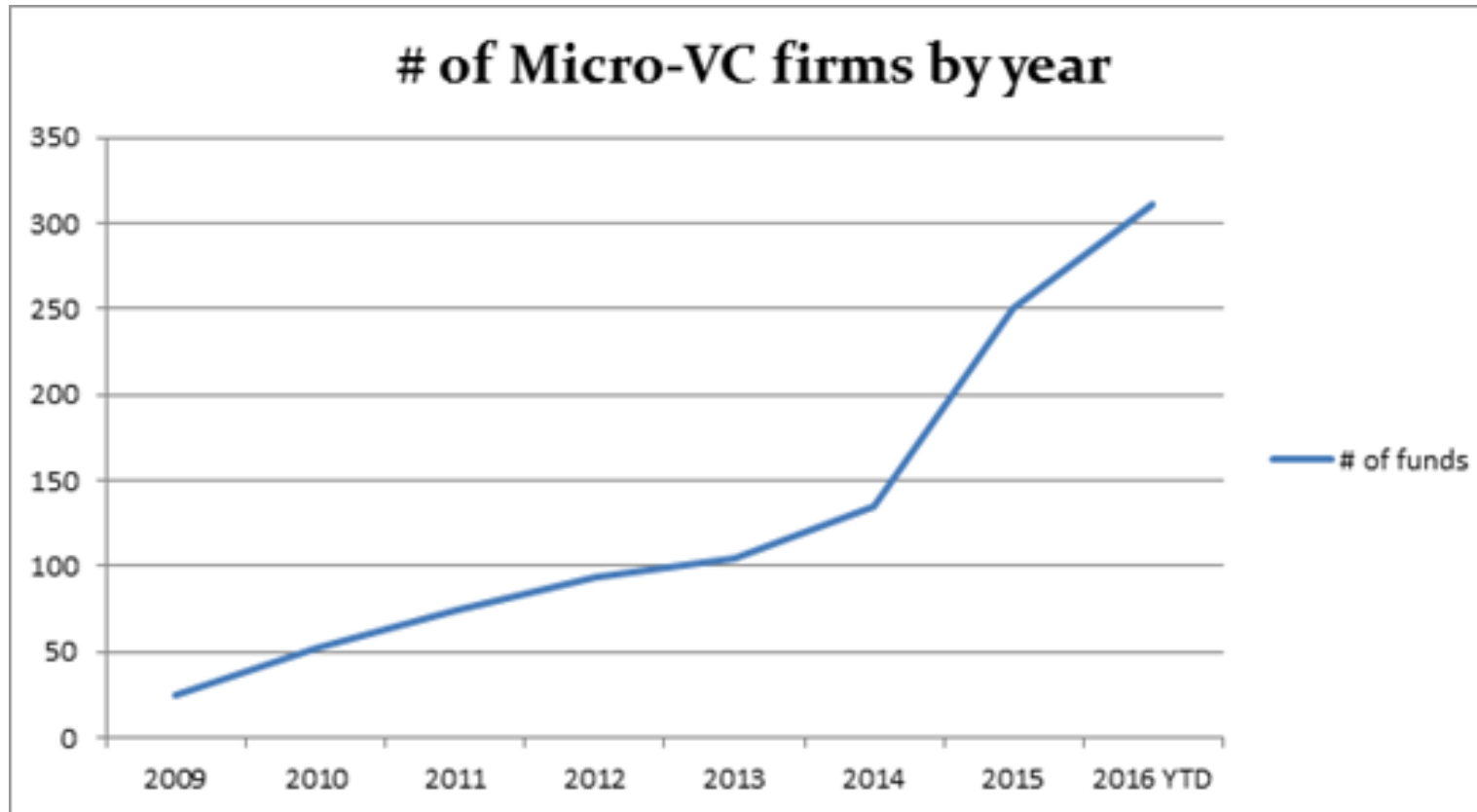
MICRO VC FUNDS (2)

- \$10m-50m total size (most are ~20m)
- Special focus on specific industries, sub-sectors
 - Monoclonal antibodies, blockchain, autonomous vehicle subsystems
- 2016: ~350 US micro funds
- 300+ raising capital

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MICRO VC FUNDS



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SIDECAR FUNDS

“Parallel” fund

- Usually for wealthy individuals
- Common but not publicized



*A suave cocktail:
The Warren Beatty of Mixology*

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SERIES A ROUND

- Named after Preferred Stock class
 - Usually 1st preferred stock issuance
- 1st “serious” money
- \$2-10m for 10-30%
- 6 months to 2 years funding
- To become a “serious” company
 - Hire professionals in specialized categories (CFO, marketing, development)
 - Hire other professionals
 - Accelerate development/commercialization
 - Begin market entry (e.g., increased sales teams)
 - Begin sales and serious metrics

Series B often required for same purposes



SERIES C+ ROUND(S): SPEND \$ FAST

- \$10m-50m
- The company has serious market traction
 - B2B: handful of major customers + pipeline
- Exchanging losses for market presence & rapid growth
- “Evidence” of near-term revenue (or acquisition)
- Team grows from 50 to 500

Demands for break-even of EBITDA are premature*

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LATER STAGE ROUNDS

- Serious money for specific objectives
- >5-10% market penetration
- Substantial revenue
 - Usually still losing money but break-even is imminent
- Expectations of exit within 2 years



LATER ROUND EXAMPLE

Ring:

- KPCB, Richard Branson, Shea Ventures, Konstantin Othmer (seed), Upfront Ventures

Date	Amount	Valuation
12/13:	\$1M	\$7.6M
06/14:	\$6.8M	\$15.3M
03/15:	\$3M	\$21.9M
07/15:	\$28M	\$63.6M
03/16:	\$61.2M	\$204M
01/17:	\$89M	\$445M

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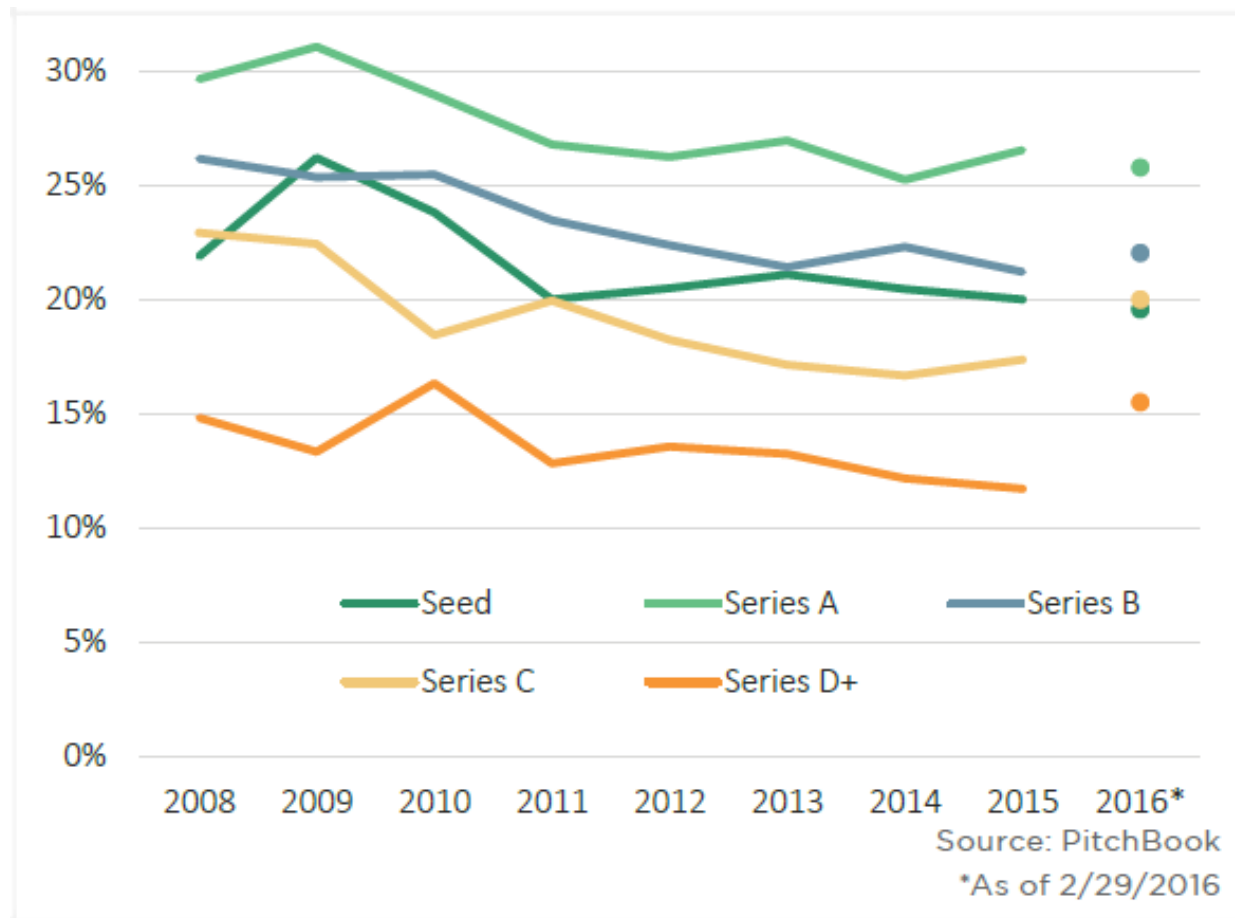


STARTUP STAGES & VC ROUNDS

Stage	Investors	Examples
Idea:	Founders	
Incorporate:	Founders + FFF + accelerator	Techstars, 500Startups, Talent Garden
POC:	FFF/angels	Pasadena Angels, IAG
Private beta:	Angels/seed	Pasadena Angeles, Susa VC
Public beta:	Angels/seed	same
Market Ready:	Seed/Series A	Canyon Creek, March
Entry:	Series A	March, Upfront Ventures
Initial Growth:	Series A/B	same
Fast Growth:	Series C+	Upfront, Sequoia
Rev Growth:	Series F+	KPCB, Sequoia, Andreessen Horowitz
Mkt Leader:	Series “N”	Same + Private equity



MEDIAN % ACQUIRED BY SERIES AND YEAR



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ANOTHER LOOK AT PRE-MONEY

Pre-Money Valuation as of 9/15:

Series A	19.0
Series B	56.0
Series C	128.0
Series D	400.0



2.2 GENERAL ISSUES

- Too much money in the wrong places
- Mega-funds and micro-funds
- Tepid exit opportunities
- A mature industry?
- Ephemeral Bias?

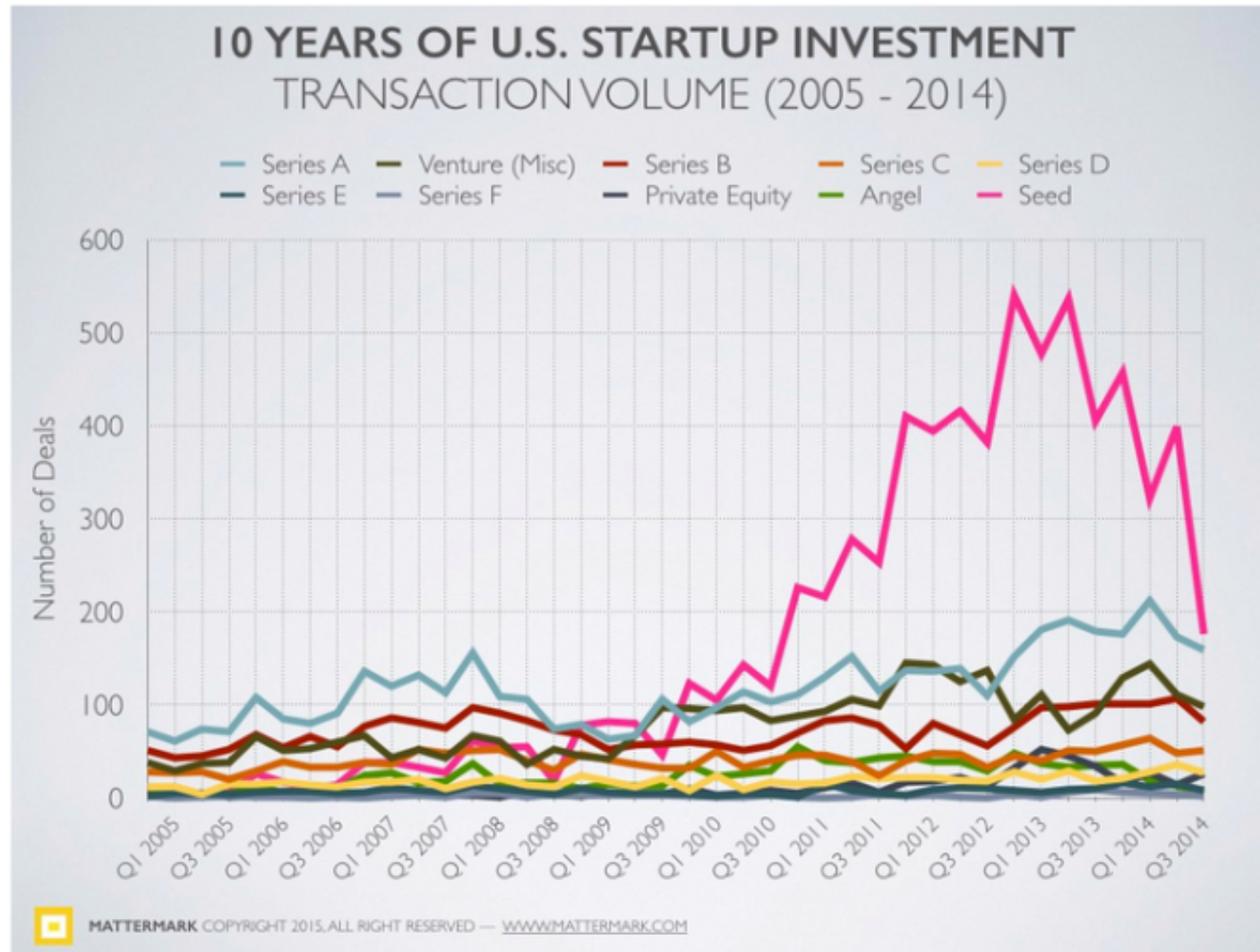


THE SERIES A CRUNCH

- 2008-2012 Seed & Angel funding increased ~5-10x.
- Series A grew ~25-50% (0.5x)



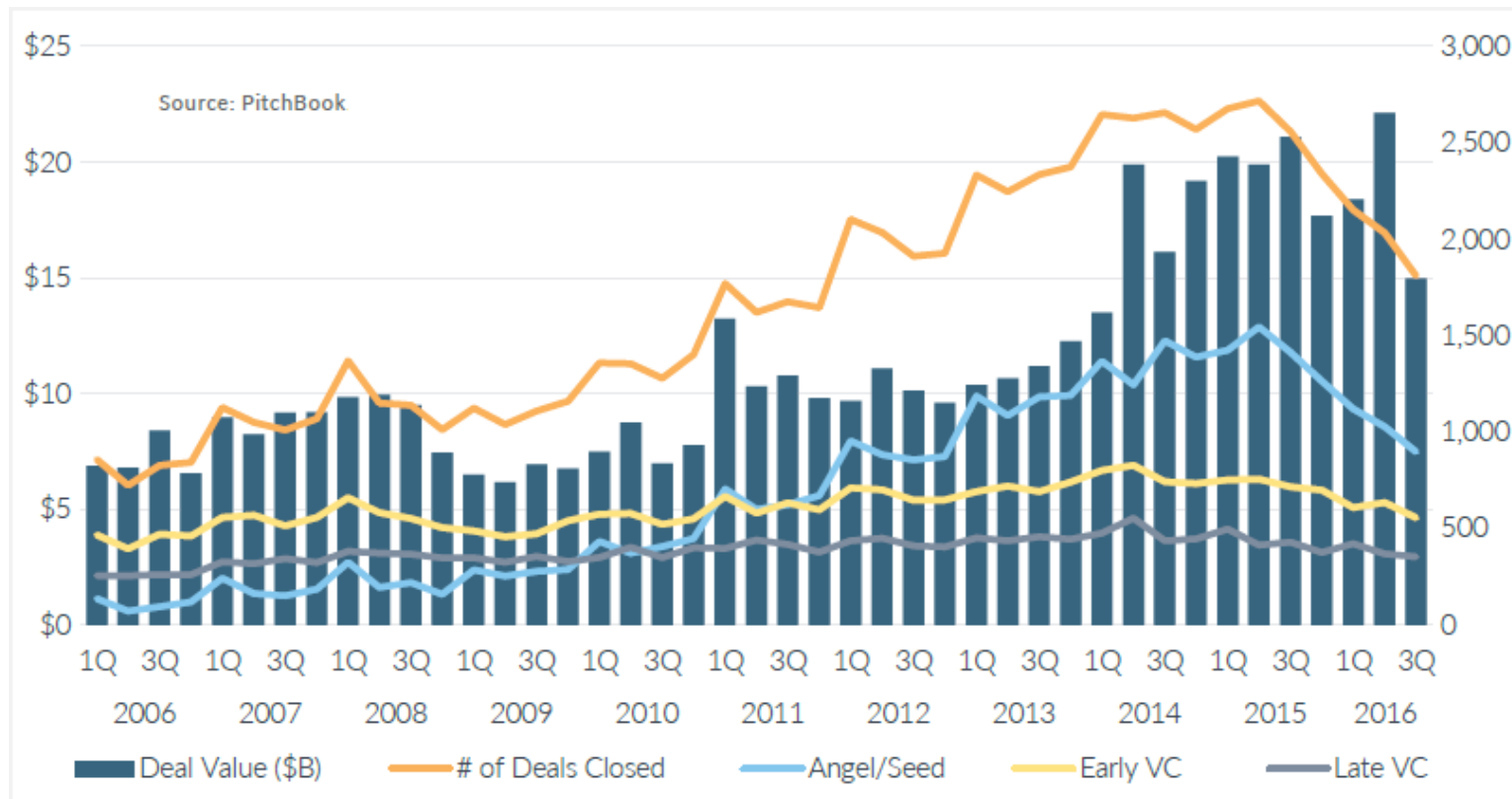
SEED SLIPPED



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US VENTURE CAPITAL ACTIVITY BY QUARTER



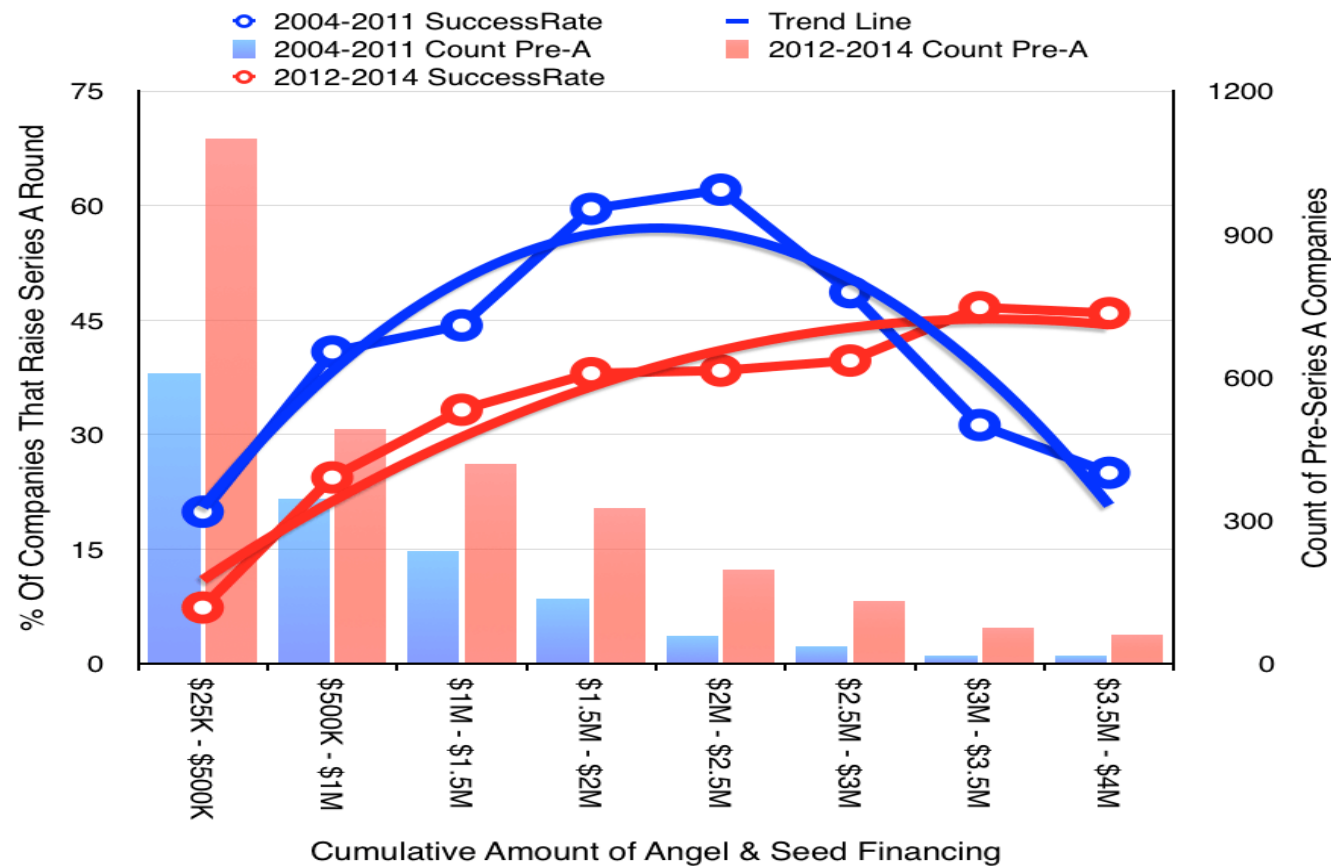
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THE CRUNCH IN NUMBERS

Percentage of Companies With Recorded Series A Rounds As a Function of Seed & Angel Funding

2004-2011 Seed Vintages vs. 2012-Present Seed Vintages



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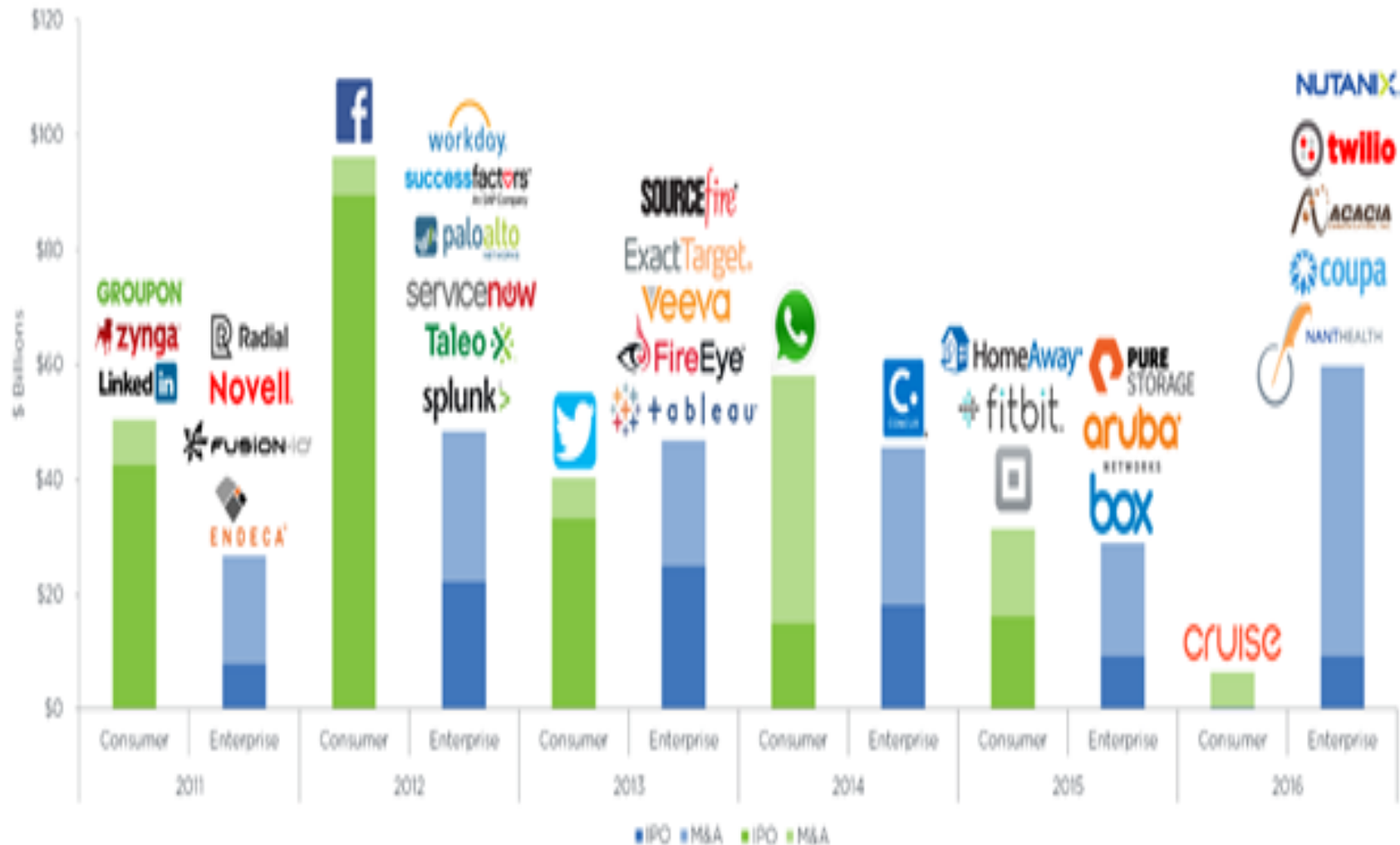
TOUGH EXIT DOOR(S)

- Total Exits 2016:
 - 513 VC-backed exits
- Declining exits (IPOs)
 - 121 in 2014
 - 76 in 2015
 - 31 in 2016
- 499 were M&A events



EXITS ARE DOWN (ESPECIALLY CONSUMER PLAYS)

Enterprise vs Consumer: Exits by IPO and M&A (2011-Date)



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EPHEMERAL BIAS?

- Bits & Bytes v. Bricks:
 - VCs prefer the ephemeral—digital v. making things or renting/buying places
 - No inventory risk, no pollution liabilities, etc.
 - Low capital investment with cloud/IaaS
- Prefer B2B over B2C
 - Easier sales (lower marketing/distribution costs)
 - More reliable revenue streams (longer term)

Counter example: Ring



3. STARTUP STAGES & VC INVESTMENT: FROM IDEA TO POC TO MARKET DISRUPTION

- 3.1 What's the Purpose & The Lesson?
- 3.2 Startup Stages
- 3.2 Matching Startup Stages & VC Rounds



3.1 PURPOSE OF EACH ROUND

Pre-Series A:

For the startup:

- Enough money to achieve your short-term milestones needed for your next round

For the investor:

- Enough money to test the team and the idea's viability *and* to get a higher valuation in the next round



3.1 PURPOSE OF EACH ROUND (CONT'D)

Series A & Beyond:

For the startup:

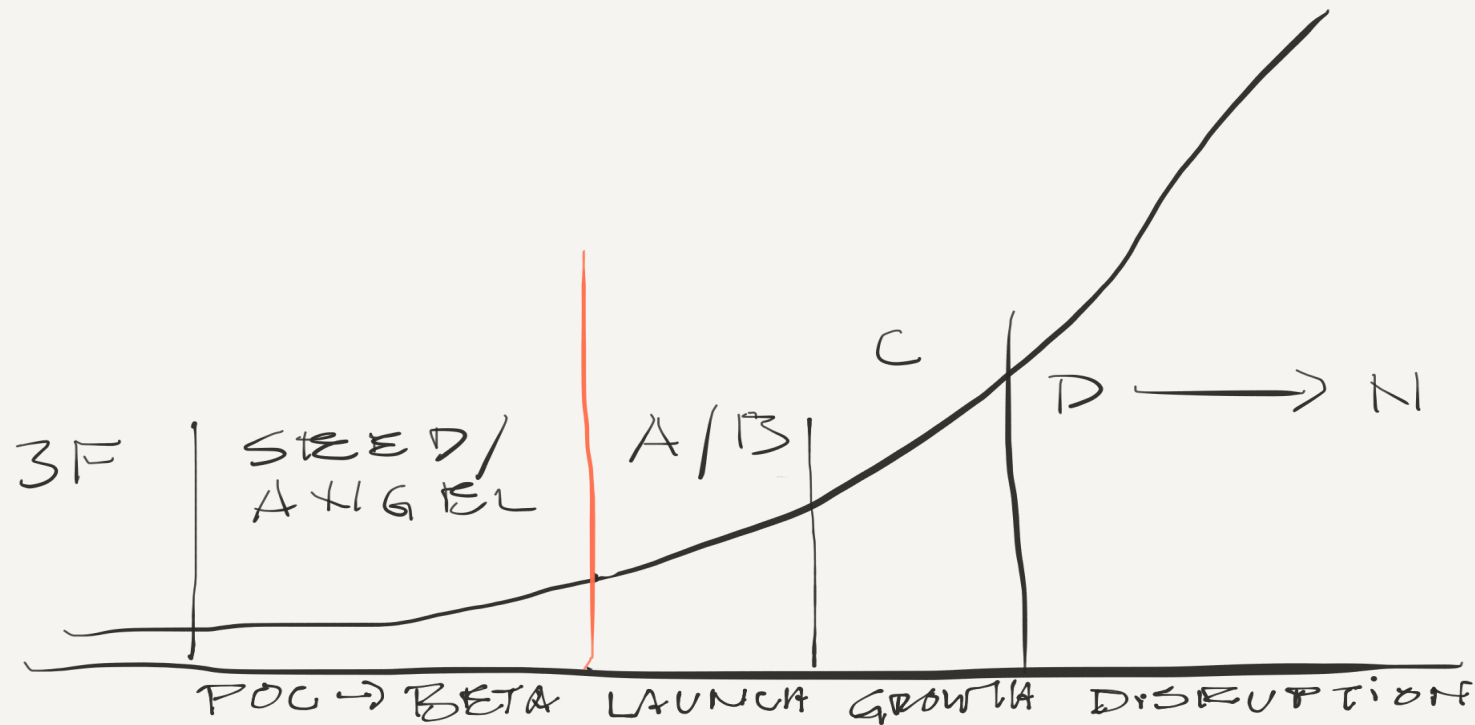
- Enough money to achieve your short-term milestones needed for your next round at a higher valuation

For the investor:

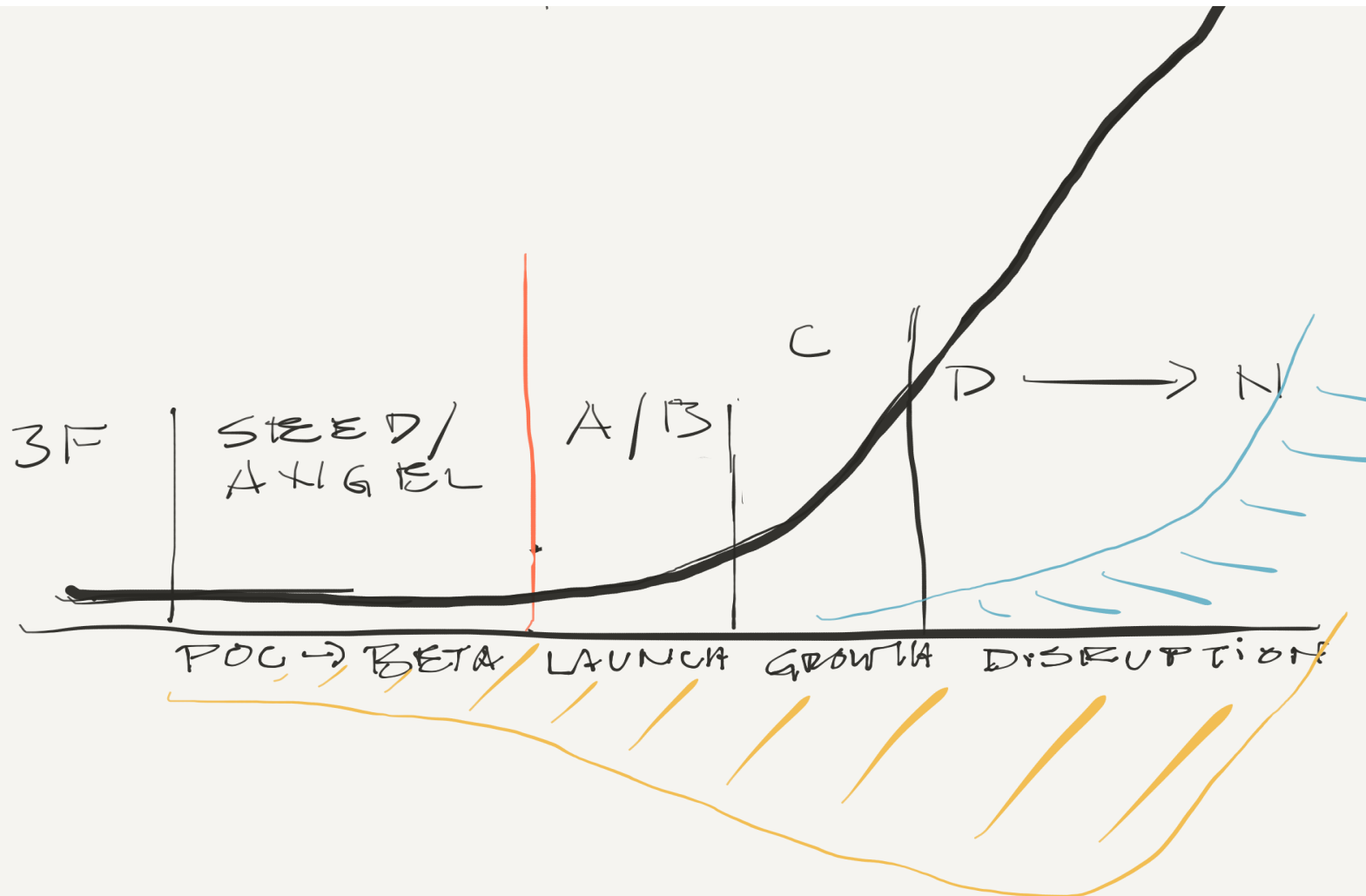
- Enough money to commercialize
- Enough money to demonstrate *your* value to your LPs



MONEY BY GROWTH STAGE



GROWTH, REVENUE & LOSS



THE LESSON

You don't ask for your first money to become Facebook:

You ask for your first money to achieve your first milestones.

And your second round to achieve your second milestones.

And so forth.

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