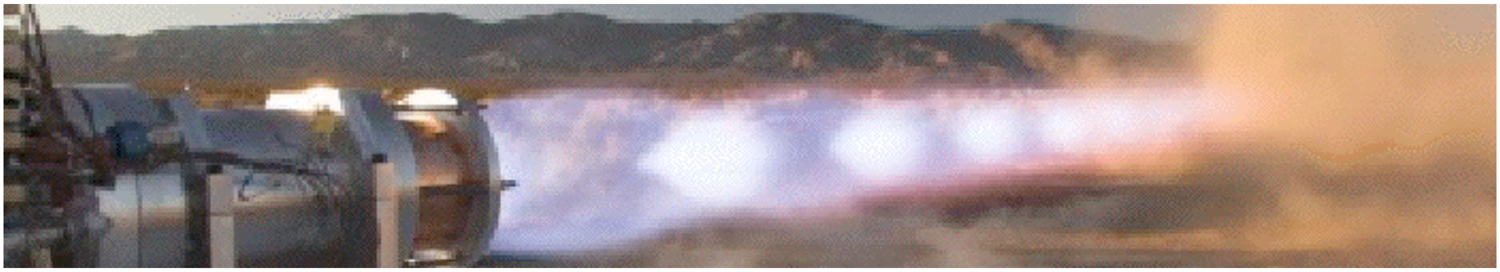


Raising Capital

Practical tips for entrepreneurs

A series of related blog posts from <http://www.academicvc.com>

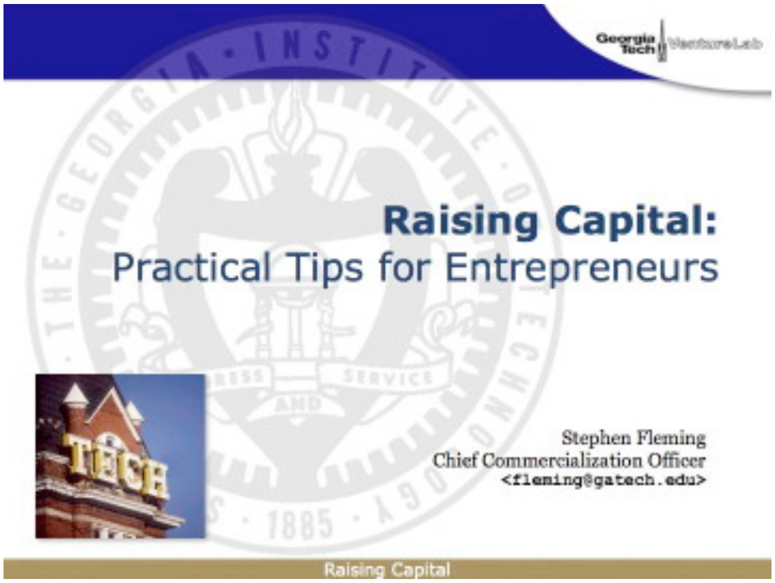
Posted by Stephen Fleming. See (cc) at end of document.

So I was teaching a class for Paul Steffes in ECE (Electrical and Computer Engineering) last week. One of the things I love about being on staff at a university is that I can drop in to a graduate class, teach to very smart people for ninety minutes, then *leave*. As I proved a couple of years ago when I was teaching in the College of Management, it's a lot tougher when you're doing it twice a week for sixteen weeks!

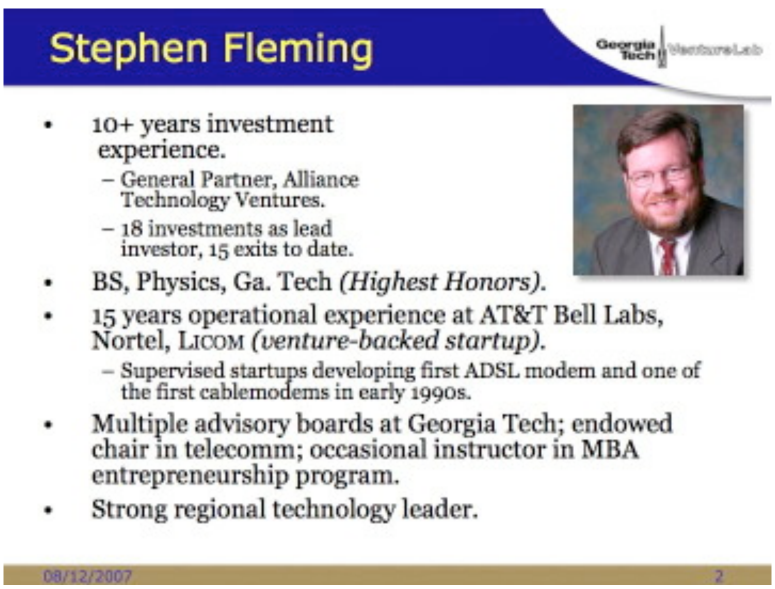
Anyhow, I gave a truncated version of my standard "Raising Capital" talk, which I've given to any number of audiences over the last dozen years. (Of course, it's evolved a bit, and continues to evolve. But the core messages don't change.) A PDF of the most recent version is posted on the Web at www.stephenfleming.net.

One of the students asked if there were a video available. I know I've been videotaped at various times and places, but I don't know what happened to those tapes. And the point isn't watching me, anyhow, but absorbing the entire message--including what's not printed in the PDF. That can be done without video.

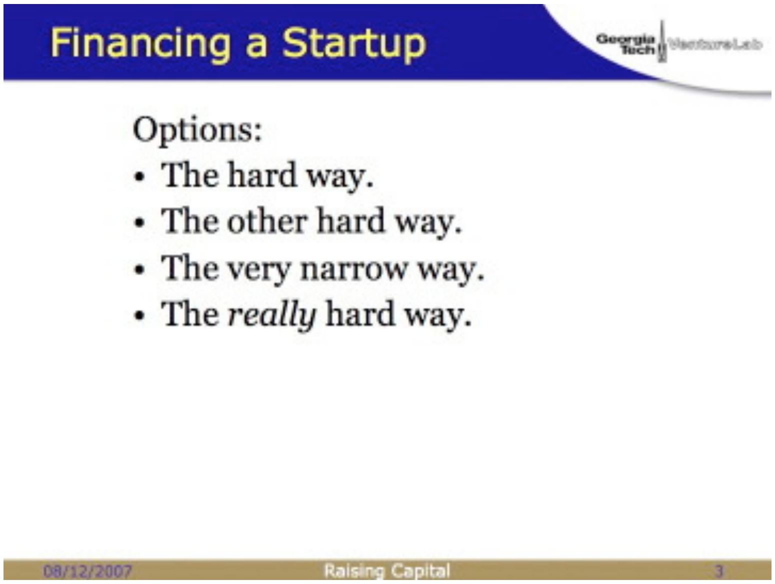
So I've decided to post an annotated version here on my blog. I'll include scaled-down images of each page, but the PDF is much higher quality.



Cover page. Yep, I work at Georgia Tech. *Standard disclaimer:* All material in this presentation reflects the personal opinion of Stephen Fleming, and does not necessarily represent the position of Georgia Tech, the University System of Georgia, or the State of Georgia. And that's a darned shame.

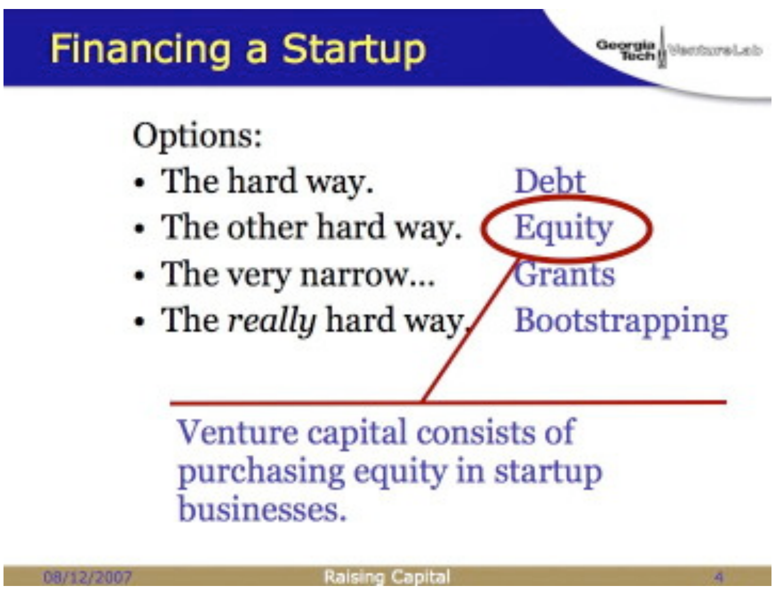


In case you've stumbled on this blog and don't know who I am.



I only know of four ways of financing a startup. (Well, there's a fifth: luck. Winning the lottery, picking wealthy grandparents, or whatever. But since that's not reproducible, I don't count it here.)

All of them are hard. If they weren't hard, everyone would do it! Some of the ways are harder than others, and all of them have advantages and disadvantages.



By and large, venture capitalists talk about equity. This is not the first definition in the dictionary:

eq·ui·ty (ĕk'wĭ-tē) the quality of being fair or impartial; fairness; impartiality

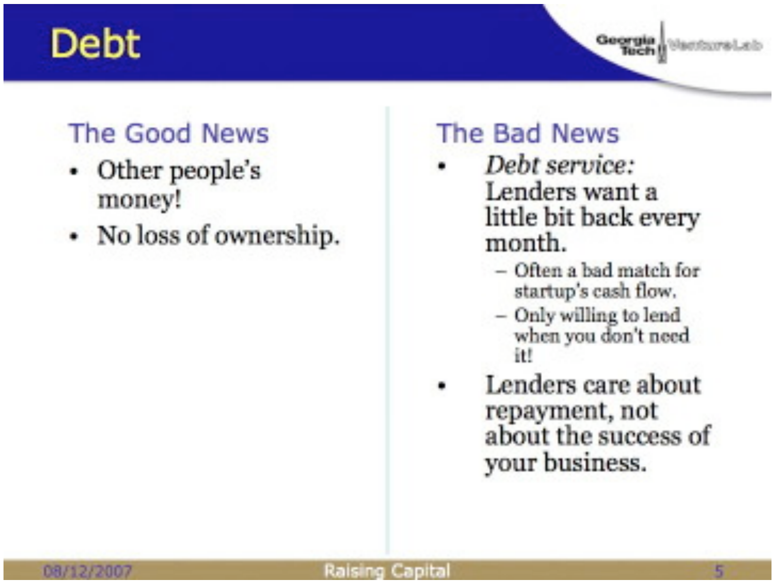
Instead, it's the third or fourth definition, depending on your dictionary:

eq·ui·ty (ĕk'wĭ-tē) the monetary value of a property or business beyond any amounts owed on it in mortgages, claims, liens, etc.

I hate to belabor the point, but I've run into cases where entrepreneurs get really confused by the multiple definitions... especially when English is their second (or third or fourth) language.

Anyhow, venture capitalists purchase equity in startup companies... typically in the form of convertible Preferred stock. (You as an entrepreneur get Common stock. Preferred is better. That's why the VC gets it and you don't.)

But let's look at all four kinds of startup financing and see the pros and cons.



I usually try to get some audience participation going at this point; unlike the PDFs, the Keynote slides (I don't use PowerPoint except when forced to) are set to not display the "good news" text until manually triggered; same for the "bad news." So I try to get the audience to volunteer their ideas for the pros and cons before I show my version.

You can read these in the image above, so I don't need to repeat myself here.

It is worth pointing out that, where I say "Often a bad match for a startup's cash flow," the point is that if your startup has any cash available after paying your bills at the end of the month, you probably would rather be hiring an additional engineer, or buying/leasing a key piece of equipment, or signing up a key business partner... *not* writing checks to the bank.

My friends in the banking business will challenge the last bullet above. I will admit that they would *prefer* that your business be successful, since that will allow them to make *additional* loans in the future. But my fundamental point remains: If you take out a 48-month loan, make all your payments on time, clear the debt, then go bankrupt in month 49... from a banker's point of view, that was a good loan.

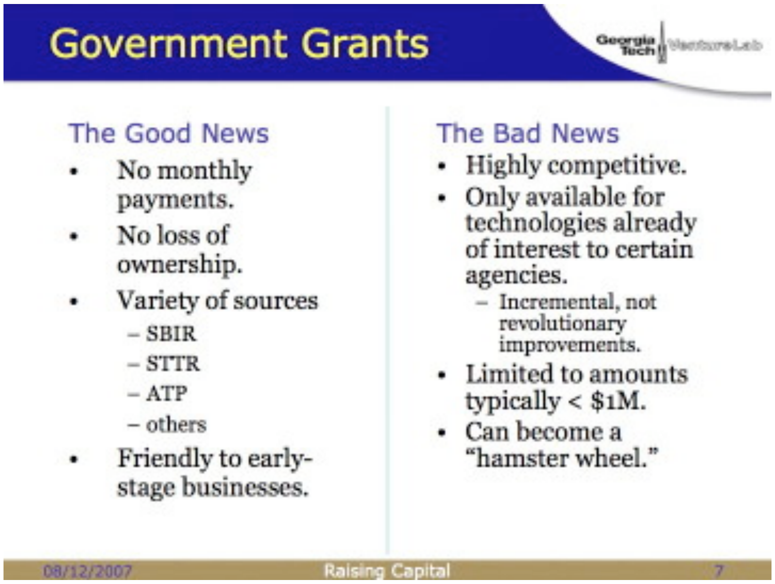
Since equity is what VCs buy, I usually spend extra time on this one.

I'm a big believer in aligning the goals of investors with the goals of the founders. That makes board meetings more congenial, since everyone is trying to accomplish the same thing (ideally, obscene capital gains).

The "long time horizon" on the left is meant to be relative to bankers... meaning you can get VC investors willing to hold your equity for 5 to 7 years before exit (and sometimes they hold it longer than that!). Still not enough for some bioscience opportunities, unfortunately.

The right-hand side is where I can normally expect someone to volunteer that some of the "bad news" about equity is "giving up part of your company." Then I go into my patented screed on "You're not 'giving up' anything... you're *selling* it to me! If you don't like the price, don't do the deal!" I'm not Jim Cramer, but I can usually wake up sleepyheads in the audience at this point.

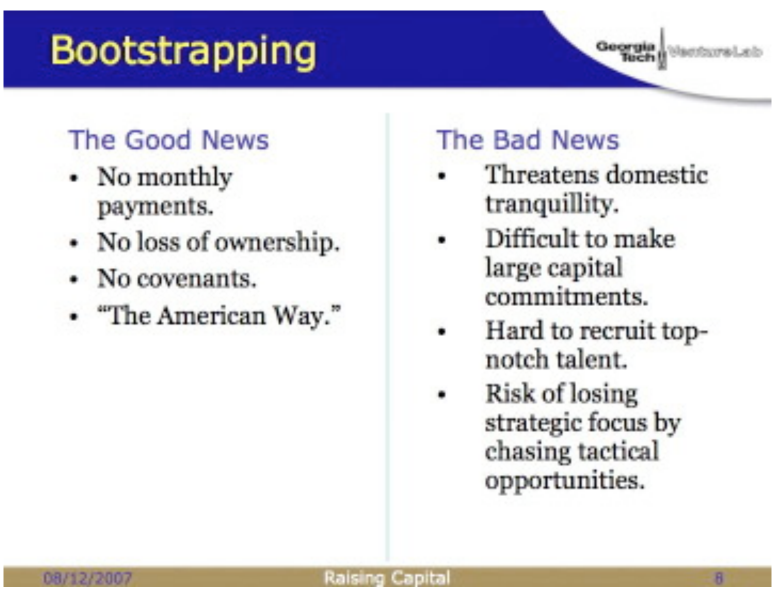
People are often surprised that VCs are thinking about selling your stock even before they write the first check to buy it... selling it to the public market through an IPO (initial public offering), or selling it to another company through M&A (merger and acquisition). But, as we'll address later, one of the differences between angels and institutional VCs is that the VCs need to give the money back at some point... they can't hold stock in your company indefinitely.



I used to neglect this financing alternative, but now that I have the SBIR Assistance Program reporting to me, it's risen in my estimation. (Live in Georgia? Want free money for your startup? Check out our Web page here! No Georgia Tech relationship required. We'll even help UGA graduates!)

For those of you who don't know... certain agencies of the Federal government set aside certain percentages of their procurements for small businesses. ("Small" to the Feds means fewer than 500 employees!)

On the right-hand side, my "hamster wheel" comment refers to those companies which make their living delivering on one SBIR award after another, without ever breaking out into commercial success. Nothing illegal, immoral, nor fattening about that, and you can make a perfectly nice living that way, but it's not likely to attract venture capital investment.



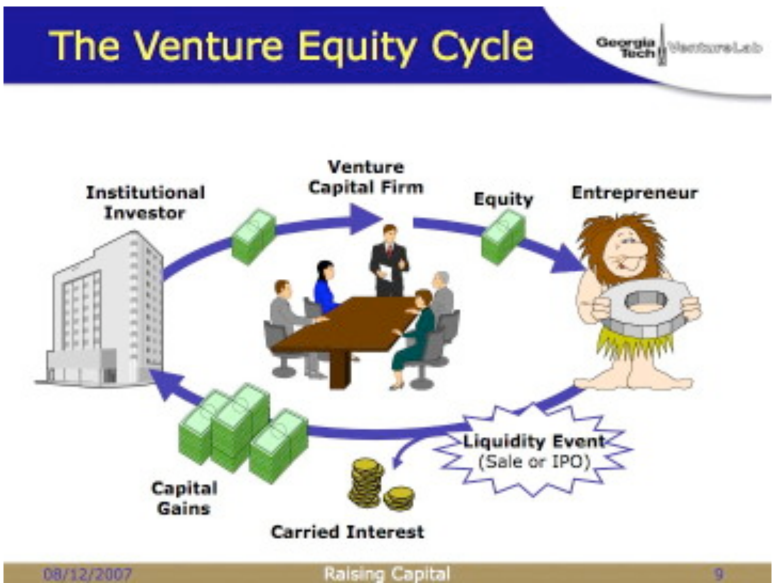
I finish my overview of financing alternatives talking about bootstrapping. It turns out that many foreign-born entrepreneurs aren't familiar with this term. There is a surprisingly complete page on this topic here (Wikipedia).

On the "bad news" side, I usually get a chuckle when I state "If you bootstrap your startup company, you *will* get divorced." It's an exaggeration, but there's a very large element of truth in there.

"Difficult to make large capital commitments" -- you're not going to build a chip fab on your Visa card, unless your credit limit is a helluva lot larger than mine.

"Hard to recruit top-notch talent" -- an industry leader is probably not going to move across country to join a bootstrapped startup with $17.50 in the bank. Hint: If you're asked to book your flight for the interview trip using your own frequent flyer points.... *don't*.

The last bullet item is a subtle trap for bootstrapped companies. If you want to manufacture carburetors and you're looking at a missed payroll... and you stumble across a customer who needs automated cheese slicers, you'll probably say "Yes, I can do that!" From there, it's a short downward slide to chalkboards, and cotton candy machines... and you find that you've completely lost your strategic focus.



When I taught a semester in entrepreneurship for the MBA students across the street, I spent an entire 90-minute class on this single slide...

The first thing to know about the venture capital cycle is: *it's not the VC's money!* They like to pretend that it is (I can say that, since I was a VC for almost ten years), but the money belongs to big institutional investors--pension funds, foundations, university endowments, etc. These entities are managing billions of dollars... sometimes tens of billions. They can invest in anything they want, as long as they're meeting their fiduciary duties. Most of their assets will be invested in stocks, bonds, and T-bills. Boring.

Most institutions will dedicate a small portion of their funds to "alternative assets." (Except in Georgia. That's the subject of another post someday.) Usually a single-digit percentage. That includes hedge funds, oil and gas partnerships, real estate, tractor factories in Uzbekistan... and venture capital.

Venture capital is equity investment in entrepreneurship. Our entrepreneur is standing at the right side of the chart, holding his new invention... the very latest in Stone Age high technology.

There's a problem: the institutional investor and the technology entrepreneur have no way to communicate. They have no language in common. They have no *concepts* in common. They need a middleman to translate.

That's where venture capitalists enter the scene. They're sitting around the table in the middle. (Our entrepreneur, slightly better groomed, is standing and giving his presentation.)

VCs are middlemen.

Their distinguishing feature is that they are able to speak two languages... the language of finance to the institutional investor, and the language of technology to the entrepreneur. That's actually not a common combination of skills, and sitting at the intersection of those two worlds gives the VC a certain measure of power. Many of them use it for good purposes.

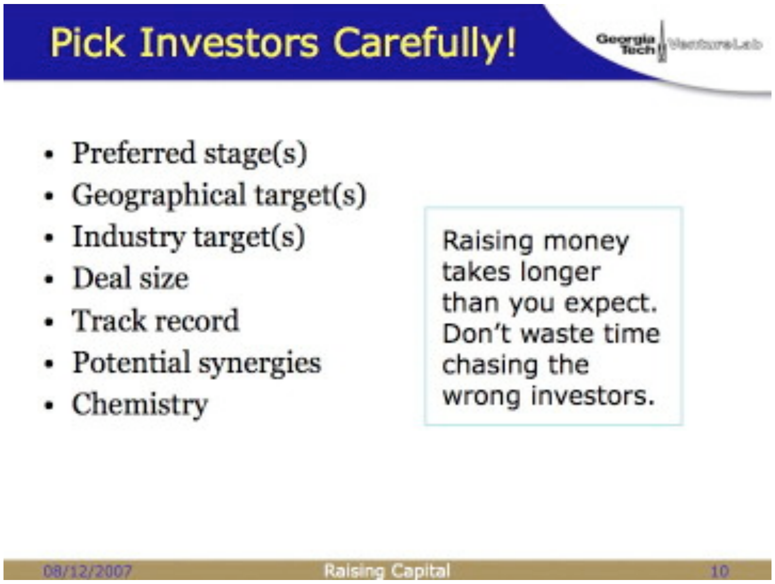
So now let's look at the cycle. The institutional investors hand a stack of cash to the VC. (Yes, it's more complicated than that. Come back for the 90-minute version later.) The VCs hand stacks of cash to startup companies. (Purchasing equity; remember the previous section?) We'll talk in the rest of this presentation about their selection process. Years of hard work follow.

If everything goes well, the company gets to a liquidity event--either through an IPO, or an outright sale of the company (or its assets) to a larger company.

(I usually get a giggle here when I explain how one of my CEOs used to have a hard time keeping his terms straight--he kept telling the board about his plans for a "liquidation event" when he really meant to say "liquidity event." There's a big difference! "Liquidation event" is selling off the furniture and fax machines before the sheriff comes to padlock the doors...)

Anyhow, after the sale or IPO, the VCs rake off their "carried interest"... usually 20% of the profits after paying back the original investment. That's how they buy Ferraris. The bulk of the money goes back to the institutional investors. Closing this cycle usually takes five to ten years, so the proceeds are long-term capital gains. If the institution is happy with the results, they make another investment in the fund, and the cycle continues.

When things break down--as they did in 2001--it gets ugly fast. Institutions stop investing in funds; funds stop investing in new deals, since they are focused on protecting their old ones; the IPO market closes tighter than a drum; VCs don't get carried interest; and institutions don't get their distributions. 2002 wasn't fun for anybody.



Not all venture investors are created equal. Most firms have specialties. Even within firms, individual partners will have specialties. Don't waste your time on firms who don't focus on companies that look like you.

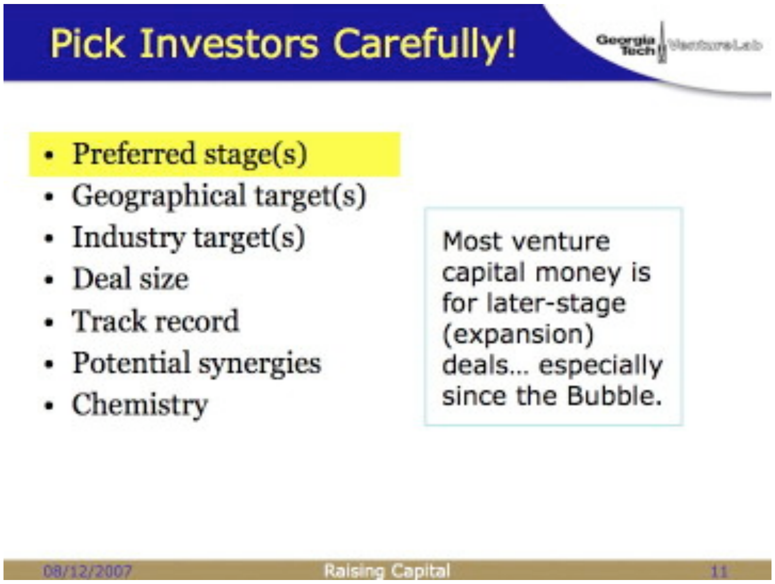
You can read the parameters on the chart above. Pay attention, and do your homework. A lot of this will be documented on the firm's Web site. You also need to double-check through your personal network to identify firms that are a good fit. Chemistry you can only figure out in person (and, no, videoconferencing isn't good enough).

There's a trap here: bigger funds have lots of associates. Associates can't make a deal happen, but they sure can *prevent* a deal from happening. So you need to be polite and responsive to them, in the hopes that they get a partner interested.

Maybe that's not going to happen at a particular firm, even if it looks like a good fit. Maybe the relevant partner is overcommitted at the moment; maybe the firm has decided to take a break and digest things for a while; maybe they just don't like you. (It happens.) But you're smart, and you're passionate, and you (hopefully) are good at explaining your technology and your market. And the associate wants to learn more... not to push your deal forward, but to increase his or her expertise and be better prepared for the next deal.

So the trap is that the associate may keep calling you back for more and more meetings... maybe camouflaging the process by bringing different associates into the mix, or a consultant, or an entrepreneur in residence. You are providing some very expensive training at your own expense (especially if you are buying plane tickets for these meetings!). And you're no closer to getting a check... indeed, you're wasting time that you could be spending with a fund that's serious about you.

Don't waste time chasing the wrong investors.

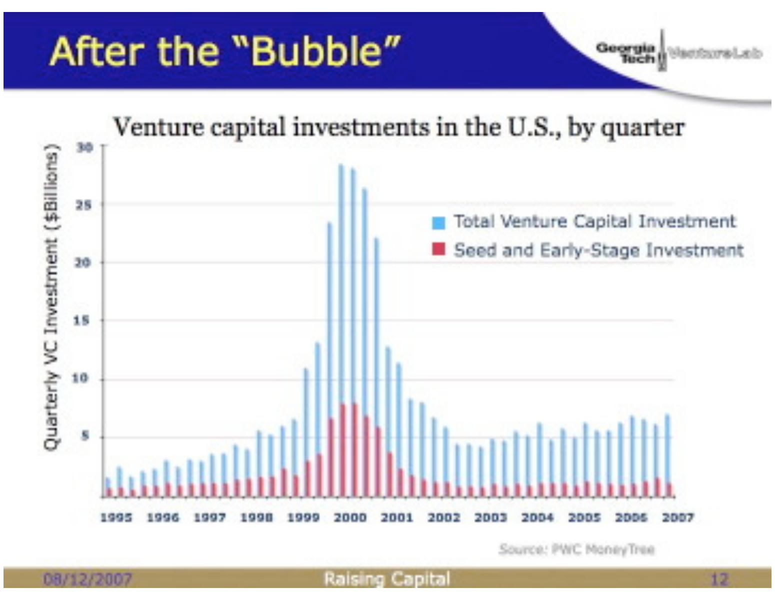


One of the most obvious things to check is whether a firm does early-stage or later-stage investing. There is plenty of capital out there--to misquote Harlan Ellison, the two most common elements in the Universe are hydrogen and capital--but most of it isn't for you.

Most capital is invested in later-stage deals, for the simple reason that later-stage deals require more capital. More on this in the next chart.

If you're an early-stage deal (and if you've read this far in my series, you probably are), you need to make sure your target investors do early-stage deals. This is an area where you can't just trust the Web site... a lot of investors will claim to do early-stage, but then you dig a little deeper and realize their definition of early-stage is "revenues of $1 million to $5 million." It's a long ways down from there to you, your dog, and your patent application.

Use your network. Ask around. Find out what deals the firm has actually done lately. Do they feel like they're in the same world as you are? If not, keep looking.

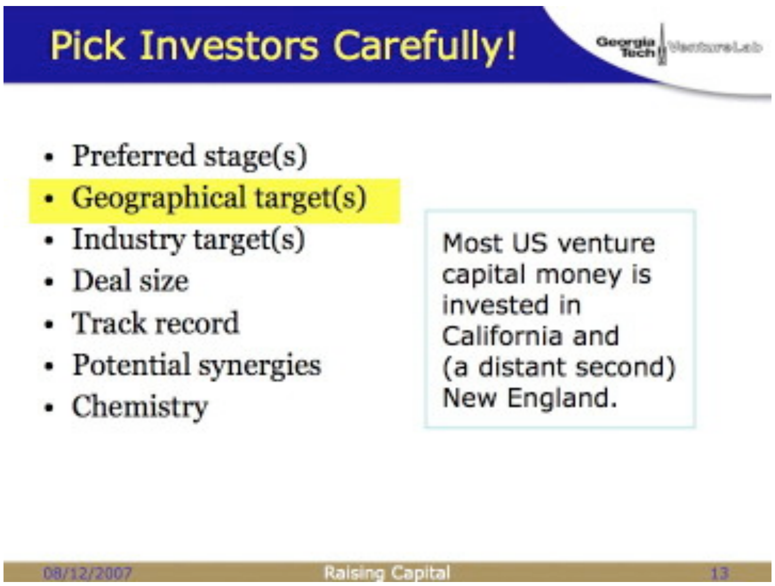


For those of you who haven't seen this curve, this was the Bubble. Yep, we all went a little crazy in 1999 and 2000. It was fun while it lasted.

But the point of showing it this time is to demonstrate that the percentage of capital allocated to early-stage deals remained relatively constant, even when the dollar volume went to the Moon. Call it twenty percent.

If you're an early-stage deal, be sure to spend your time with investors who make up part of that twenty percent. It may be flattering to get called by SuperMega Ventures, but the likelihood of a billion-dollar firm investing in your pre-revenue startup is slim.

(Slim. Not zero. Read up on "barbell strategy." I would attach some links, but a quick Google search is complicated by pages of fitness equipment.)

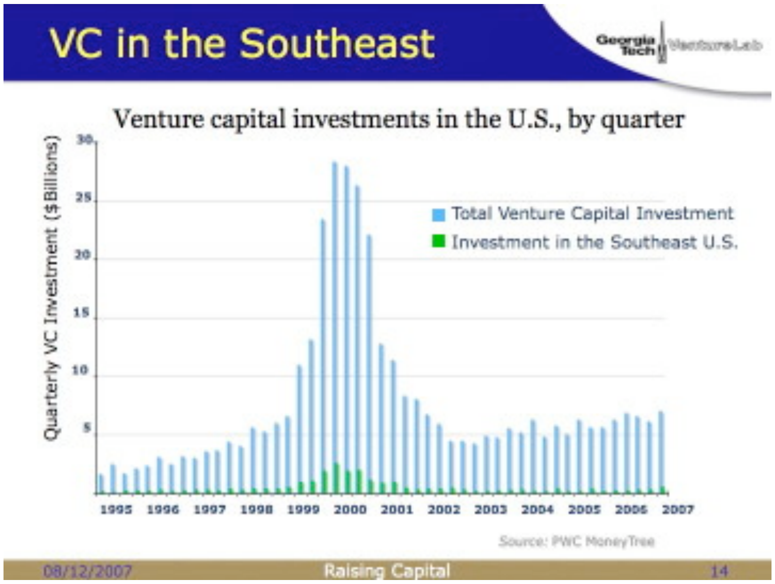


I'll come back to this one in more detail later... but, for now, you need to figure out if a particular firm is going to invest in your geography. (Or, alternatively, if you're willing to move to *their* geography. Bay Area VCs are particularly bad about wanting you to move to their back yard. If you're young, single, and unattached, this may be an option. Hope you like having a roommate. If you're married with kids and a nice house, you are in for a shock. Be sure to take your spouse on a househunting trip *before* you sign the term sheet. I'm serious.)

Cue the Gatlin Brothers:

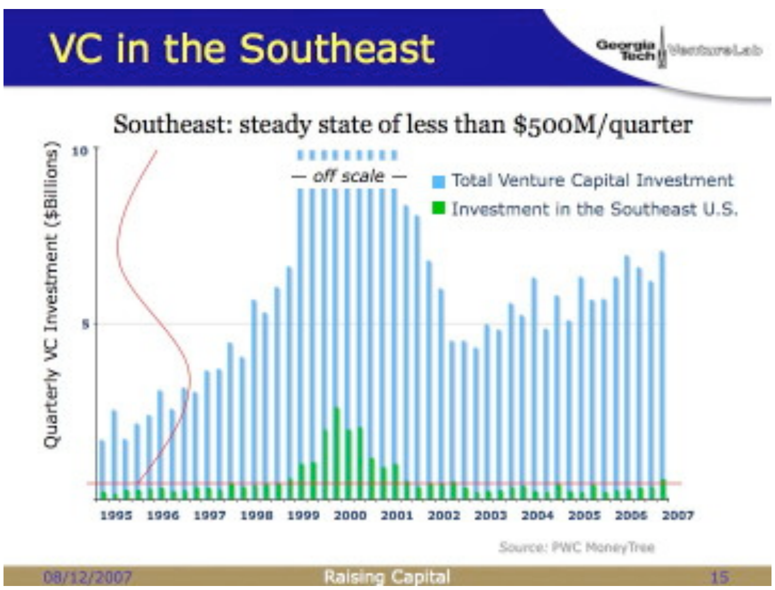
> All the gold in California
> Is in a bank in the middle of Beverly Hills
> In somebody else's name

If you're not in California (or New England), don't despair. Next chart.



Yep, it's the same Bubble. But this time, I've shown the amount of capital invested in the Southeast. It's in green.

Yes, it's on the chart, smarty-pants! Okay, okay, next chart.



Okay, I've increased the vertical scale. You can't see the magnitude of the Bubble, but everything else is the same.

So, ignoring Bubblicious behavior, the Southeast seems to be relatively stable at about half a billion dollars per quarter. Is that good or bad?

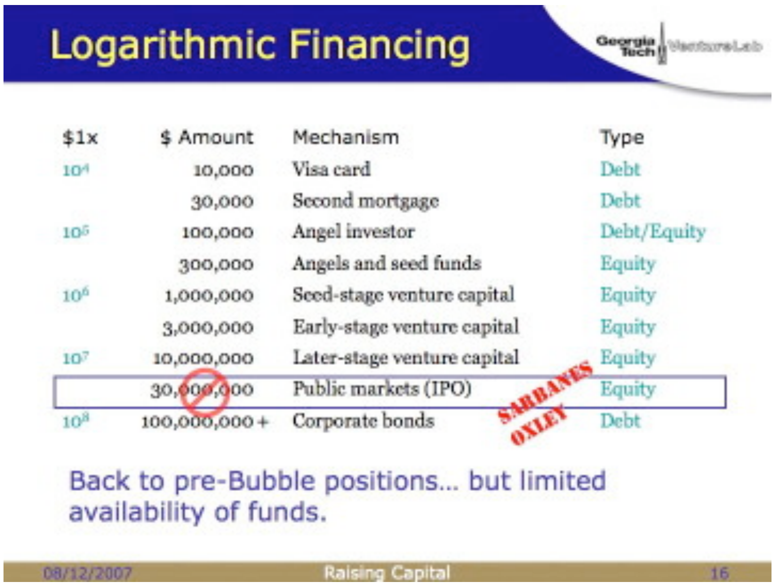
Glass half full: Half a billion dollars a quarter is a lot of money!

Glass half empty: Yeah, but it's peanuts compared to the rest of the country.

Glass half full: Well, it's more than *your* deal requires, so you should have no problem getting funded.

Glass half empty: Since the Bubble burst, we've been relatively flat, in a national market that's growing. That can't be good.

You make the call. But, no matter what, you probably should read the book *Raising Capital When You Don't Have A Silicon Valley Address* by Keith Herndon. Go buy it now. I'll wait.



If you have an engineering background, you know that the real world works in logarithms. So I'm showing various amounts of capital on a logarithmic scale.

Lots of entrepreneurs start out with debt. If you need $10K, put it on your Visa card. If you need $30K, second-mortgage your house. Either way, you're not of interest to equity investors.

(There's a recent exception to this, exemplified by firms like Y-Combinator, who are targeting young entrepreneurs who have maxed out their Visa cards and who don't have houses to second-mortgage. Doesn't change the main point.)

It's around the $100K point that most entrepreneurs (and their spouses) run out of resources to plow into their startup, and that's the traditional territory for angel investors. Some angels will do a mix of debt and equity, or maybe they'll do a convertible note in order to not screw up the pricing of a future venture round. But if you need this kind of money, you're probably either selling equity, or promising to do so soon. Refer to previous charts.

From $300K to $10M, you're in the world of venture funds. Different funds will have different appetites for risk/reward, so you need to do your homework, but this is where VCs make their living.

It used to be that, if you needed $30 million dollars, you were probably ready to take your company public through an IPO. The Sarbanes-Oxley Act of 2002 changed all that. You might get a flavor for how successful this act (often known as SOX or Sarbox) has been by noting that both Senator Sarbanes and Representative Oxley declined to run for re-election in 2006.

The problem with Sarbox is that it's designed for Enron, but it hits your little struggling Web 2.0 startup like a ton of bricks. This is the "invisible foot" of government applied to your internal operations if you go public (or are thinking of going public, or getting bought by a public company). To quote Wikipedia:

> The cost of complying with SOX 404 impacts smaller companies dis-proportionally, as there is a significant fixed cost involved in completing the assessment. For example, during 2004 U.S. companies with revenues exceeding $5 billion spent 0.06% of revenue on SOX compliance, while companies with less than $100 million in revenue spent 2.55%.

0.06% is barely noticeable. 2.55% can mean the difference between a profit and a loss.

The Iron Law of Unintended Consequences has led to (1) many NASDAQ-traded companies choosing to "go private", (2) other companies choosing to go public on foreign exchanges such as the London AIM, and (3) increased appetite for private equity by growing companies that choose not to go public at all. So, yes, you can blame SOX for the decline of New York compared to London as a financial center, *and* for hedge fund excesses!

(I'm exaggerating. This is a blog. Check out Inc. Magazine on the same topic for less exaggeration but the same conclusion. Or the Wikipedia article is very good.)

Net result for you: Since the IPO threshold is higher, VCs have fewer exit options, which drives down valuations of private companies all the way up the page. Deal with it. And write your congressman.

(In 2005, Ron Paul introduced HR 1657, which read, in its entirety,

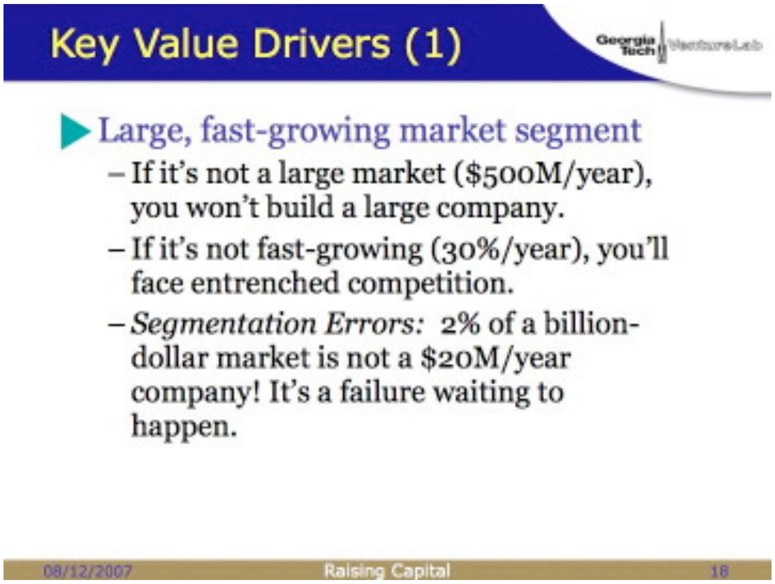
> Section 404 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7262) is repealed.

Of course, it went absolutely nowhere in Congress.)

Last line: If you need $100 million, you're Disney or GE. You can borrow money without going hat-in-hand to a bank. Float a bond issue and quit bothering me. :-)

The most common question a VC gets asked is "What sort of deals do you invest in?" Most of them will give variations of the same answer... looking for a fast-growing market, strong technology, great management, at a fair price. And it's nice to have milestones to know when you're winning.

One at a time:



"Large" and "fast-growing" are both necessary and neither alone is sufficient.

If' it's not a large market, you can't build a large company. Duh. You might utterly dominate the market for left-handed widgets, but if very few people want to buy left-handed widgets, you're still going to be a niche player.

Less obvious is why the market has to be fast-growing. Classic example: automobiles are a multi-billion dollar industry, but (in the U.S.) sales are flat or growing at single-digit percentages. So becoming a new entrant there is suicidal, since the established vendors will fight to maintain their existing market position. And it's very romantic to think of yourself as David versus Goliath... but Goliath usually wins.

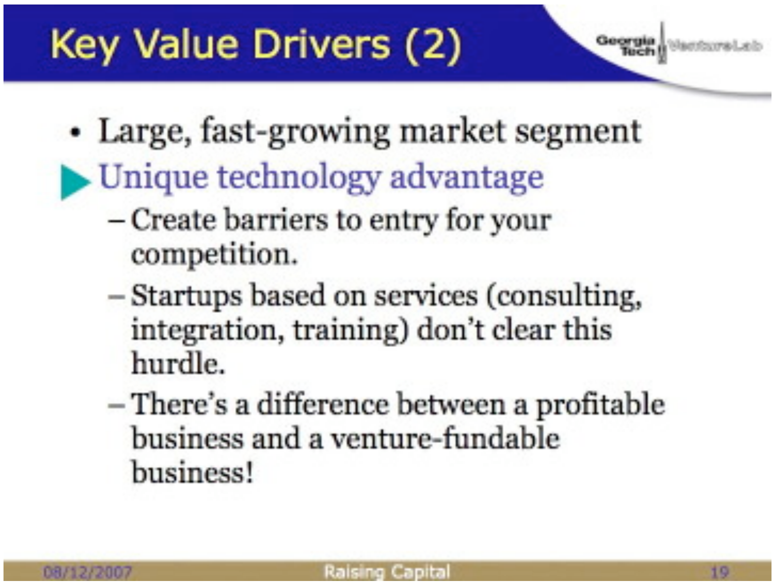
(And dinosaurs lasted one heck of a lot longer than mammals have so far, and it took an asteroid to finally do them in.)

This is often linked to a segmentation error. Too many startups say something like "It's a billion-dollar market; all we need is two percent, and we'll be doing $20 million a year!"

Mistake. Mature markets shake out into patterns; a common one is a 50% player, a 30% player, a 15% player, and a bunch of losers. If you're targeting 2% market share, you're telling potential investors "I want to be a loser!"

So re-segment your market, and see if there's a way to be a winner. Look at automotive again. Note that a new entrant like Tesla Motors isn't saying that they're going to be a 0.1% player in the overall vehicle market. They're saying they're going to be the dominant player in the market for *electric* vehicles. That shifts the question back to basics--is that segment big enough and fast-growing enough? That's a much more useful discussion than arguing over whether you can capture 0.12% or 0.15% of a bigger, but mostly inaccessible, market.

(In 1992, John Sculley did this precisely wrong. He released the Apple Newton... but instead of claiming it would be the dominant player in a then-nonexistent PDA market, he kept talking about a $3.5 *trillion* converged market for computing, communication, and entertainment. His math was accurate, but suicidal. Newton sales of several tens of millions of dollars were actually pretty impressive... but as a percentage of $3.5 trillion, it looked like a complete failure. Oops. The Newton went away and, shortly thereafter, so did John Sculley.)



The next hurdle to jump is having a unique technology advantage. (Note that I do *not* say patents. Patents are wonderful, and nice if you can afford them, but there are other ways to build and protect a technology advantage.)

You're really trying to create a barrier to entry for your competition. I don't care how smart you and your engineers are... most of the smart people in your industry do not work for your company. And they're not static--they're going to try to figure out smart ways to compete with your new company. Deal with it.

John Warner of SwampFox points out that there are ways to build companies whose advantage is in supply chain, or other elements of value creation, not just technology. He's right. But some of those start looking like service companies, and it's hard for service companies to attract venture financing.

Why? Linearity. Most service companies--consulting, systems integration, training, etc.--have outputs that scale linearly with inputs. If you want twice as many lines of code, you need to hire twice as many programmers. If you want to teach twice as many courses, you need twice as many trainers. (*Or* a disruptive technology, which proves my point.) Linear scaling is fine, and you can make an excellent living that way... but you shouldn't take venture money.

Go back to the Venture Equity Cycle chart. VCs need *non-linear* deals where you can double the inputs and see outputs increase 10x. Or 20x. Or 100x.

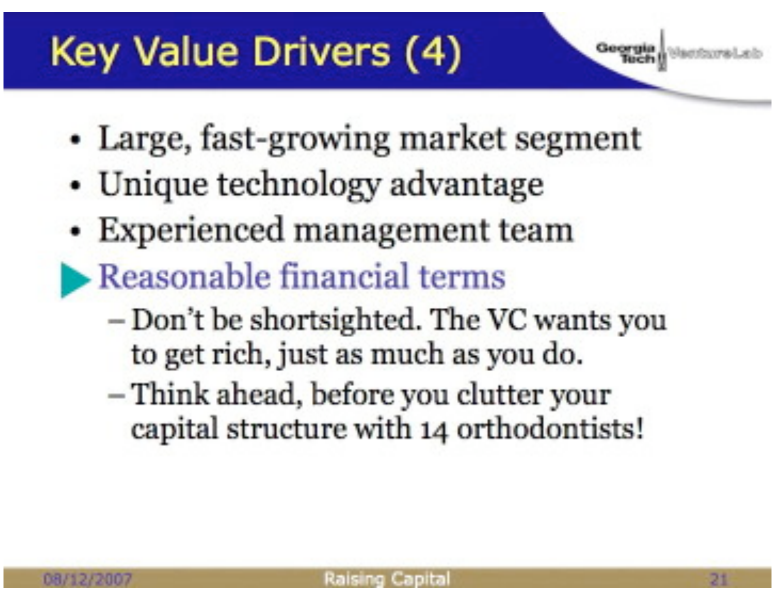
There's a difference between a profitable, successful, attractive business and a venture-fundable business.

Know which one you are.

You need experience to get funded, but you need funding to get the experience. [Catch-22](). (Younger audiences tend to look puzzled at this point. Does no one read anymore? Sigh.)

The best possible CEO for your company is someone who has done something exactly like this twice already and has made money for the investors both times. If that's not you, your investors will sooner or later start looking for that person. Cooperate.

There's a whole discussion to be had on the lifecycle of CEOs (check out [this book]() for a good overview), but the truth of the matter is, experience counts. You may not have the relevant experience. Worse, no one in your city or state may have the relevant experience. In the South, we call this the "[carpetbagger]()" problem. Be prepared.



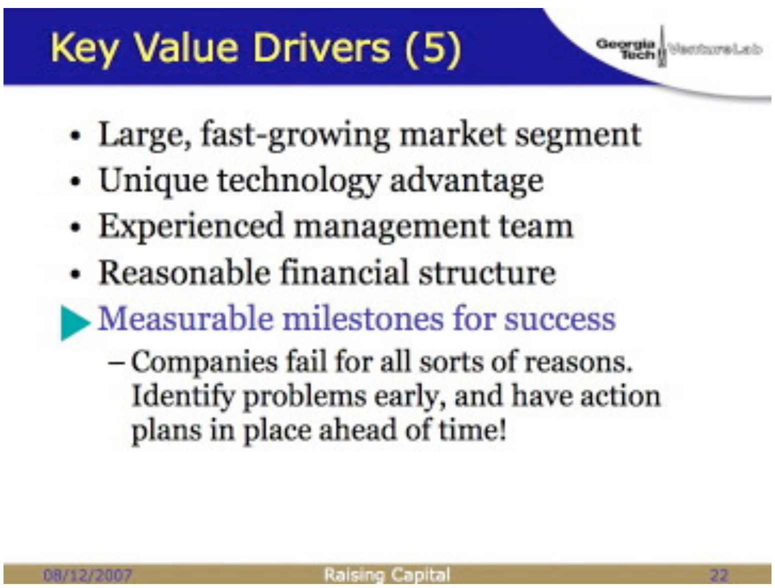
People who haven't been through the process tend to think I'm lying about this one. But it's true.

Yes, there are "vulture capitalists" out there, but if you do your homework, you can avoid them. Most early-stage venture investors really *do* want to see you get amazingly, ridiculously, gloriously rich. Because if you build a company with enough value that *you* get rich, the VCs get rich also. And so do their investors (see the Cycle again), and life is good for everyone.

And wealthy entrepreneurs are one of the best advertisements possible for a VC firm. ("Hey, team, XYZ Ventures backed Joe Doakes with his startup, and he just bought a personal dirigible! Let's make sure we talk to XYZ before we show this deal to a bunch of other VCs.")

We'll talk more about terms later, but if you see any terms that make you start thinking of vultures... remember that vultures are carrion birds. They eat things that are already dead. If you company is alive and thriving, most VCs want to see you do well from it.

And if you have another path to raising the money--my "fourteen orthodontists" from the chart above--get some good advice as to what this might do to your capital structure, and what the consequences might be down the road. It'd be a shame if a poorly-structured $200K angel round now were to screw up your chances for a $4 million VC round later.



This one seems obvious, but a lot of people miss it. VCs aren't going to hand you $4 million and say, "Great! Go build your widget and let us know when it's ready. See you in a couple of years!" They're going to want to see milestones. Initially, every month. Later, every quarter. And they're going to want to know what's Plan B (and Plan C, and...) if you miss those milestones. The most painful kind of lost venture money is money that's pumped into a business after you should have already known it was in trouble.

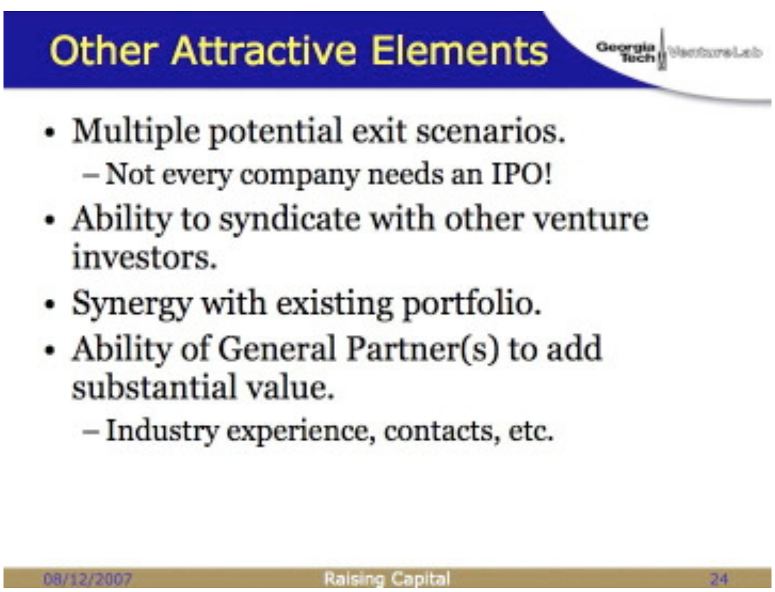
(Side comment: treat milestones as truth checks. If you're really not meeting them, maybe you should reconsider what you're doing. Don't scramble around hanging wallpaper and laying carpet to cover up fundamental cracks in your walls and foundation.)

The good news is, most VCs will not dictate those milestones; they'll have input, but at the end of the day, you'll be the one making the promises about what you can and can't deliver. Make promises that you can keep.

So, if you look at successful startups, it's like the opening of *Anna Karenina*: "All happy families are alike; each unhappy family is unhappy in its own way." Experienced investors have seen enough deals, good and bad, to recognize patterns of success, and they'll only invest in deals that fit those patterns.

If you're outside of those patterns--you may be an excellent investment, but you are going to have problems finding a venture investor to step outside the box and take the risk.

(VCs are actually very risk-averse. Don't let their public relations fool you.)



Let's say you've met all five criteria in the last few slides. Good for you! Unfortunately, so do a bunch of other deals. All things being equal, VCs will use secondary elements to make decisions on who to invest in.

This is your chance to shine! But it involves doing your homework.

Everyone can throw the sentence "We expect a liquidity event via IPO or M&A after reaching profitability in Year Five." Yawn.

Dig deep and provide some detail here:

> We expect to be an attractive acquisition target to major players in multiple industry sectors. [List those sectors.] In the widget space, potential acquirers include A, B, and C. [Obviously, list their real names... Google, Boeing, Pfizer, whatever.] "Player A" has acquired three companies in the last five years [list them], paying an average of 8.7X earnings. According to our projections, that would value us at $125M.
>
> "Player B"... etc.
>
> In the blivet sector...etc.

You get the idea. Remember, the VC doesn't make money when you sell your product; he (or she) makes money when you sell your company! Get them excited about what that sale might look like.

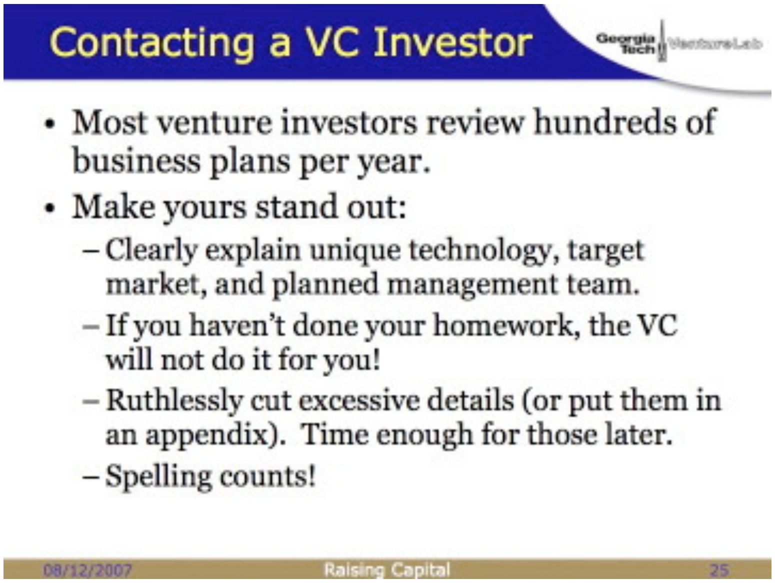
Most VCs will want to syndicate your deal... meaning share it with other similar investors. Frequently, the same two or three firms will do multiple deals together. When you're targeting a particular VC, figure out who their favorite partners might be, and do your homework on *them*, too.

What sort of homework? Synergy with the existing portfolio is a big one. If you can say "I know that you've invested in companies A and B. Here's how our product can extend their functionality, and why we'd make good partners for them, and here are some customers that we could attack together"... you have just demonstrated that you've done your homework, and that you understand the nature of the VCs job.

Don't force-fit a synergy if one doesn't exist... but if there is one, be sure to point it out.

Finally... most VCs used to do something else. Do your homework on them as individuals, not just as representatives of their fund. For example, I used to be a telecom geek, so I'm a sucker for telecom deals... especially ones where my (sadly, aging) Rolodex can help out by identifying a customer contact, or a key hire, or a sympathetic analyst.

None of these elements are secret. VC Web sites leave literally hundreds of trails to follow, and Google is your friend.



Unless you've already demonstrated your ability to make millions for your investors in prior deals, you're going to have to prepare a business plan before talking to VCs. (You'll have to do one in any event, but if you're less experienced, it's earlier rather than later.)

Fact of life: VCs are deluged with business plans. I've been handed business plans at conferences... at restaurants... one foolish but enterprising fellow even drove up to the front door of my house and rang the doorbell. (Yes, I'm in the book. It's not an open invitation. *Don't do that*.)

It used to be that the expense of printing and shipping business plans provided a rough-and-ready filter... but those days are gone. The cost of emailing a PDF file is zero... so a *lot* of PDFs get emailed. VCs have to separate the wheat from the chaff very, *very* quickly. His or her default state is going to be "What reason am I going to find to reject *this* one?" You have to break through that... getting them past each internal objection until the logical next step is to invite you in for a presentation.

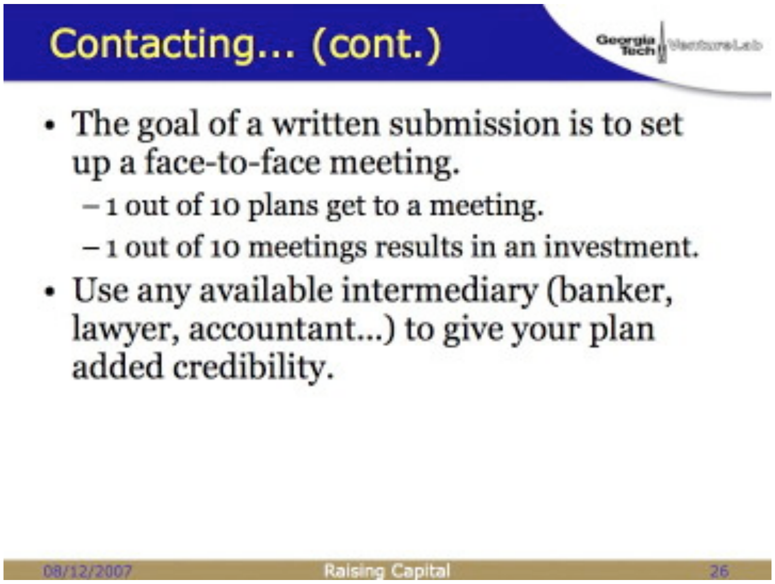
At this point, your business plan is a marketing document as much as it is anything else. You get twenty pages before the VC gets bored and rejects you out of frustration. In the first two pages, and then again in the next eighteen, you have to clearly explain your value drivers (see previous post).

You may have to write 200 pages to crystallize all your ideas. That's fine; it's not wasted. Don't throw those pages away. But you're going to have to compress everything into twenty clearly-written, hard-hitting pages before sharing with a VC. There will be time enough for the 200-page version if and when you get to the "due diligence" phase. Later.

And, finally, I tend to tick off engineers with my last point, especially those engineers who weren't born in the United States: *Spelling counts*. And I'm using that as shorthand for all the mechanical details of creating a document... spelling, grammar, consistent typefaces, lining up tab stops, page numbers, all those picayune details that have nothing to do with the quality of your idea. Why do I care?

You're creating a document that you're going to send out into the wild alone. When someone reads it, the words (and graphics, if any) on the page have to communicate your vision without you being there. So that document needs to represent your best work. And I treat it like a Rorschach blot of what I would see from you as a CEO... do you pay attention to detail? Are you logically consistent? If spelling isn't your strong suit, can you recruit someone to help you who's better at it than you are? What's it going to be like to work with you?

If the business plan reflects that you're either sloppy or lazy or stupid, I am going to assume that you're sloppy or lazy or stupid as a CEO. That's not a good motivation for me to invest in you.

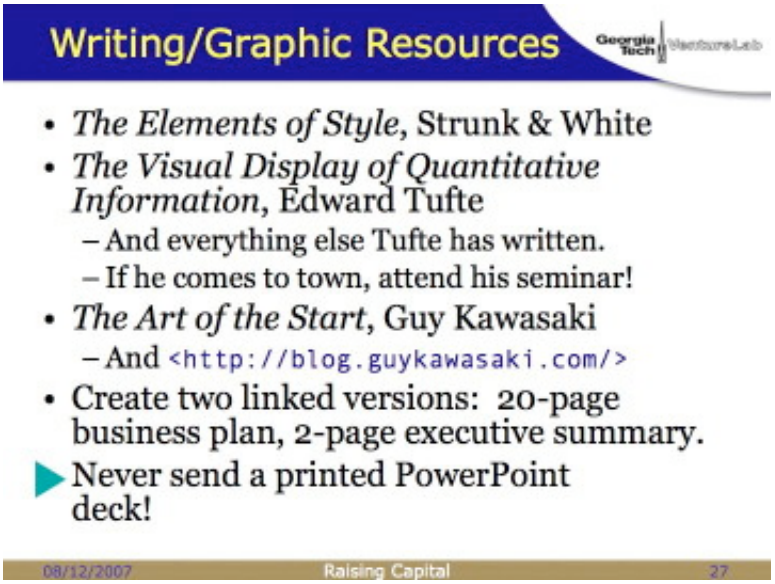


Remember how I said, at this point, your business plan is a marketing document? That's because its main purpose at this point is to get you to a face-to-face meeting with potential investors.

I'm showing that "1 out of 10 plans get to a meeting; 1 out of 10 (initial) meetings results in an investment." That's actually a bit optimistic, but whether the odds are 100:1 or 300:1 against you, the message is the same... you have to stand out.

Human nature being what it is, one of the best ways to stand out is to be recommended by someone the investor knows and trusts. Some firms will publicly state that they never invest in deals that aren't sourced through their network. Other firms aren't as blunt about it, but the reality is the same. Mass-mailing your plan to a dozen (or a hundred, or a thousand) VCs is a complete waste of time and resources on both ends. Repeating the theme from earlier slides: do your homework, target your potential investors carefully, then figure out how to get to them through a trusted intermediary.

Cynics will say "It isn't what you know, it's who you know." Not necessarily. If you and your target VC don't have any friends in common (but you might be surprised; check what LinkedIn has to say), go make some new friends. Lawyers, accountants, recruiters... their lifeblood is relationships, and they're easy to make contact with. Buy a few breakfasts or lunches; it's a cheap investment to build those relationships.



When I present these charts to a roomful of technology entrepreneurs, I usually ask for a show of hands at this point. Three questions: "Any English majors in the room? Any state spelling champions? Anybody who was raised in a household whose primary language was not English?" Usually there are zero hands for the first two questions, and anywhere from ten percent to half of the room for the third.

This is a problem.

Your written documentation is going to have to represent you to people who you haven't met. It has to be your "best foot forward," and it should represent an example of your very best work. If I read a plan that's sloppy, or poorly written, or with misspellings and typographical errors, what am I supposed to conclude?

1. You are stupid, and don't know that you have made errors.
2. You are sloppy, and don't care that you have made errors.
3. You are lazy, and don't want to take the time to fix errors.
4. You know there are errors, but you do not have sufficient skills to fix them, *and you have not gone out to get help from someone who can*.

None of these make me want to invest in you as an entrepreneur. The first three are self-explanatory. The fourth ties into one of your key roles as the leader of an entrepreneurial startup -- your ability to assemble a team of individuals who, together, are greater than the sum of the parts.

It's weird that people don't see this. If you're a software type, there's no shame in hiring a hardware type to lay out your circuit board. If you're the technical lead, everyone expects you to hire a financial type to keep the numbers straight. You can't do everything (unless you're Leonardo da Vinci), and you're not *expected* to do everything. What you *are* expected to do is find people who, collectively, *can* do everything. If you're no good at writing a business plan or preparing a presentation, *find someone who is*.

(I'm not saying you should hire someone. Use a friend, or a fellow student, or your girlfriend's roommate who majored in graphic design, or your Mom. Buy them a pizza or a gift certificate to Kyma or whatever, depending on how much work is involved and how lousy your first attempt is.)

In order to make your first attempt less lousy, there are some resources you can call on:

First, you need to get a copy of *The Elements of Style*. It's ten bucks; if you can't afford ten bucks, you can't afford to be an entrepreneur. Read it, re-read it, stick it under your pillow at night.

Second, start channelling Edward Tufte. His first book is *The Visual Display of Quantitative Information*, and you need a copy. It's not as cheap as Strunk and White (about $30 online), but that's just the start. He has three more books at this writing, and he travels the country giving presentations about his work. The one-day course costs about $400, but you get all four books, and you get to spend a day with someone who really *understands* how to convey complex information cleanly and quickly.

Follow this link and find out when he's going to be in your town. Go.

Finally, you ought to pick up a copy of Guy Kawasaki's *The Art of the Start*. Guy has a notorious personality, and he makes a living out of letting it show, but there is a wealth of good information in this book. Good advice about all aspects of starting a company, but particularly relevant here are Chapters Two and Three.

You need to create two documents for distribution: a twenty-page business plan and a two-page executive summary. Which basically means a 2-page executive summary and 18 pages of supporting material.

This is **hard**. You are going to have two hundred pages of material you'll want to shove into this plan. Resist the temptation. Because your target audience won't read it. You want to get to a meeting... there will be plenty of time for details later. Cut ruthlessly. Then cut some more.

An easy tip (more about this later)... cut out almost everything related to your neato-keen technology. Out of the twenty pages, you can have two on technology. Not three. Two. Because I want you to spend the remaining sixteen pages (two more got chewed up by the executive summary, remember?) talking about your team, your company history, your customers (if any), your revenue (if any), your competitors (you *definitely* have some), your channel strategy, your potential acquirors... you know, all that stuff that might actually make me want to invest in your company!

Don't cheat by using 8-point type and 9-point leading. And watch the borders! I'll notice. And, if you really want to impress me, talk to your girlfriend's graphics-design roommate about typefaces. Times Roman and Arial advertise that you're lazy enough to accept the default settings. Not a personality characteristic of a great entrepreneur. (Steve Jobs has wizened Japanese artisans hand-carving the unique letters for his presentations out of pristine granite cubes. Well, actually, no, but you get the idea.)

The 20-page business plan and the 2-page executive summary should agree. That sounds obvious, but people often get it wrong. If the executive summary says you're raising $2.5 million but the "Offering" section of the plan says you're raising $2.0 million... I no longer care which of those two numbers is correct. *All I care about is that they are different*. See "stupid or sloppy or lazy," above.

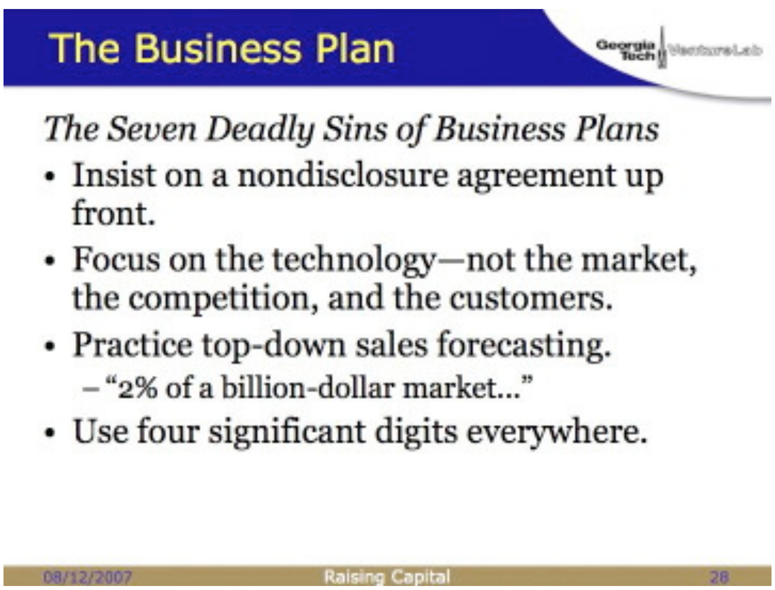
At the same time, they shouldn't agree word-for-word. If I read a paragraph (or page!) in the executive summary, then encounter that exact same paragraph (or page) later in the document, I notice. "Hmm. This entrepreneur has so little to say that he just cuts-and-pastes the same description in different places." You can get away with that for a brief memorable tagline (ten words or fewer), but not stretches of expository text.

This sort of thing is where it really pays to have someone else proofreading your document. Maybe two people: one who understands your business, and one who is just doing "copy editing"... not analyzing the meaning, just making sure the technicalities are observed. And as I said in December, *spelling counts*. And don't trust your computer's spellchecker! If you type that you are "confidant of our results" when you meant "confident," no spellchecker on Earth is going to save you from looking stupid.

Finally (and to conclude this over-long post), I always advise people to never send out a naked PowerPoint deck. (Of course, I'm using "PowerPoint" in the generic sense, like "Kleenex" and "Xerox". Obviously, all of the cool entrepreneurs use Keynote for the Mac instead. :-)

Why? Ideally, your PowerPoint deck shouldn't function without *you* standing in front of it talking. These slides (the ones I'm annotating in this series of posts) are lousy in this regard, but I've created them as a standalone teaching tool... and I'm not using them to raise money! I'll have more to say about presentation slides in a future posting, but for now, try very hard to resist when a VC asks you to "just send over your PowerPoint deck." Suggest sending the 2-page executive summary instead. If he or she insists on the slides, don't be stupid -- send them, but *also* send the 2-page executive summary. The summary has nice things like verbs and complete sentences which mesh better with our cognitive processes. PowerPoint slides encourage brevity to the point of meaninglessness, and whiz-bang graphics to the point of mindlessness.

Edward Tufte does a better job of criticizing PowerPoint than I can do. I've already told you to buy his books... but, as a sample, here's an explanation of how PowerPoint killed seven astronauts in the *Columbia* re-entry disaster.



So it's always nice to talk about "Seven Deadly Sins"... there are probably more when it comes to business plans, but these are pretty basic.

Yes, I have seen plans that commit all seven!

---

1) Insist on a non-disclosure agreement up front.

Venture capitalists don't sign NDAs. At this point (2008), neither will many angel investors. Get over it. If the first page behind your cover page is an NDA, most investors will close the cover and toss the document in the trash. (If you're into saving trees and don't actually print your business plan, that's fine. Update metaphor accordingly.)

Why? Brad Feld gives as good a summary as I have ever seen, and further quotes Guy Kawasaki:

> Before you even start addressing the hard stuff, never ask a venture capitalist to sign a non-disclosure agreement (NDA). They never do. This is because at any given moment, they are looking at three or four similar deals. They're not about to create legal issues because they sign a NDA and then fund another, similar company--thereby making the paranoid entrepreneur believe the venture capitalist stole his idea. If you even ask them to sign one, you might as well tattoo "I'm clueless!" on your forehead.

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2) Focus on the technology--not the market, the competition, and the customers.

This one is common. Founders of startups tend to be passionate about their technology, and that passion leaks out all over. Including into their business plans.

As I said last month...

> Cut out almost everything related to your neato-keen technology. Out of the twenty pages, you can have two on technology. Not three. Two. Because I want you to spend the remaining sixteen pages (two more got chewed up by the executive summary, remember?) talking about your team, your company history, your customers (if any), your revenue (if any), your competitors (you definitely have some), your channel strategy, your potential acquirors... you know, all that stuff that might actually make me want to invest in your company!

There will be plenty of time to talk about your technology later. For now, I just need enough of a taste to get hooked.

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3) Practice top-down sales forecasting.

Again, an amateur mistake. It's a red flag when I see "The market is a billion dollars a year, so all we need is 2% and we're a $20M/year company." *Bzzzt*. **Wrong!**

Not because the math is wrong (it's not). But because mature markets tend to shake out into a 50% player, an 30% player, a 15% player, and a bunch of losers. If you're targeting 2% share, you're saying "I want to be a loser!"

(Or you want to be Apple. Great; I respect that. But I probably wouldn't *invest* in it as a startup strategy today.)

That's top-down sales forecasting, and it's useless. Professionals do bottoms-up sales forecasting: Example:

> "Our average sales cycle is XX days. We have XX sales professionals on board now, and are hiring XX over the next quarter. The new ones will take XX weeks to come fully online. At steady state, each salesperson can handle XX accounts simultaneously while chasing XX

> prospects. Our conversion rate from prospects to sales is XX% per month. This translates into a sell rate of XX widgets per month starting in Q4. Average selling price will be reduced to $X to allow for anticipated competition, so Q4 sales are anticipated to be $XX0,000."

Okay, now you have my attention. We may disagree on the assumptions, and we can have interesting fights over sensitivity analysis, but at least I know I'm not dealing with an amateur.

Note that you will back into a market share calculation here that actually has meaning, rather than sticking your fingers into the wind and making a wild guess. If your share isn't 15% or better, perhaps you need to re-scope your market--not "share of wiki sites," but "share of SaaS wiki sites hosted for SMBs." Does it still sound interesting? Compelling?

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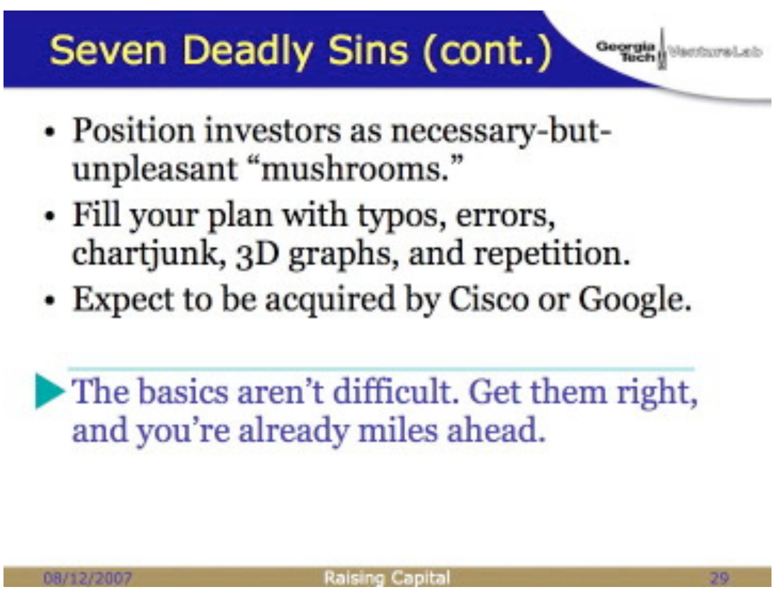
4) Use four significant digits everywhere.

I touched this one in passing two paragraphs back. If you say your sales forecasts for the fourth quarter are $320,000, then I may be happy or sad about that number, but at least you're not advertising that you're an idiot. If you say your forecasts are $321,783.45", then I *know* you're an idiot. I don't invest in idiots.

Don't just regurgitate numbers because Excel calculated them for you. Excel has a ROUND() function. Use it, early and often, and establish reasonable error bars on your forecasts. Two significant figures everywhere is about right. Three should be backed up by some historical experience. Four or more is silly.

(This is about the only place where I miss slide rules. Yes, I had one. No, you couldn't get arbitrary precision out of it... you had to learn to live with two significant figures, plus a third which you estimated and which was frankly questionable. False precision is another red flag for sloppy thought processes.)



5) Position investors as necessary-but-unpleasant "mushrooms."

You know how to raise mushrooms: keep them in the dark and feed them plenty of... um, manure. Investors hate that. If you're smart enough to run the company without any advice from anybody, I hope you're rich enough to run it without any money from anybody, too.

Every VC claims to be "value-added." A pleasingly-high percentage actually are. When you do your diligence on the firm (yes, you should do diligence on them, just like they are going to do diligence on you!), figure out which is which... and you should only be targeting the ones that really do add value to your company. Once you've picked value-added investors, let add value! Bring them in to your thought processes and decision-making!

Otherwise, you run the risk of surprising them. Investors hate surprises. (Even good ones.)(Really!)

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6) Fill your plan with typos, errors, chartjunk, 3D graphs, and repetition.

I touched on this in the previous post but let me emphasize it here. If you make mistakes in your plan, I'm going to assume that you are stupid, sloppy, lazy, or incapable of getting help. None of these make me want to invest in you as an entrepreneur. For "chartjunk," see Tufte.

And, for crying out loud, if you're not displaying three dimensions of information, don't use a three-dimensional chart. The only reason to use the 3D charts in Excel are to intentionally obscure your data and try to hide something you're not happy about. Red flag!

As Jorge Aranda says, "Excel must be the most powerful enabler of graphic disasters in the world. Most people don't have the time, or the dedication, or the skill, to improve Excel's default graphic settings." Set yourself apart: *Learn*. Or hire someone who knows already.

(As you might expect, the graphics defaults for Apple Numbers, their spreadsheet package, are infinitely more attractive than for Excel. But the principle remains... if you're just prettying up the numbers, *stop*. Is this really what you want to be doing in a business plan?)

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7) Expect to be acquired by Cisco or Google.

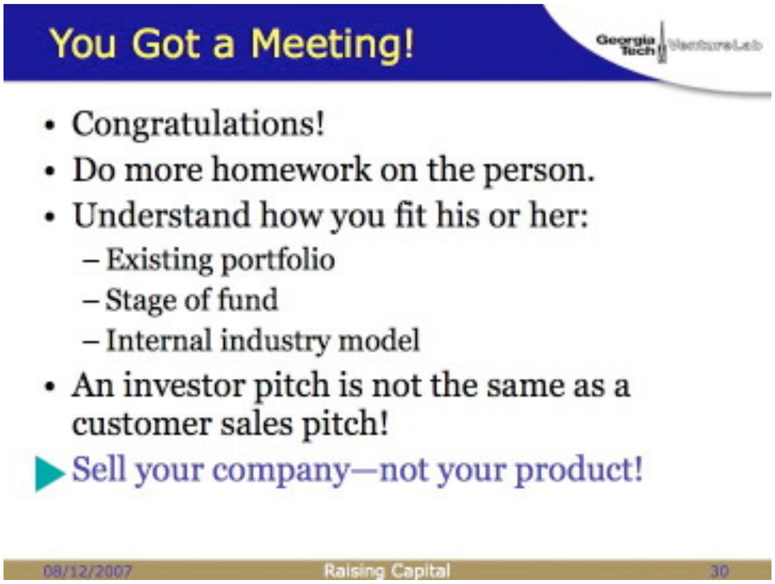
This slide used to say "Microsoft," but the boys in Redmond have had a rough decade (and their proposed acquisition of Yahoo is just sad). Google and Cisco are still hanging in there, and continually building value by acquiring bright young startup teams. *But* there's a limit to how many companies Google and Cisco can buy, and there are a lot of great startups out there... more than that limit.

Don't set your focus so narrowly that there are only one or two or a handful of potential acquirors. Build enough value that lots of companies will want to assimilate your team, your customers, your product, and you (probably in that order). That's what leads to bidding wars. Cha-ching!

Repeating a comment to my previous post--if I'd seen this earlier, I'd have linked to it more visibly:

http://www.scottburkett.com/index.php/atlanta-business-scene/2008-02-16/having-fun-down-at-tech.html

Good advice there from another member of Haynie's Atlanta Startup Posse.



Earlier I said "Your business plan is a marketing document as much as it is anything else." As several of us have discussed on Lance Weatherby's blog, some investors today may not actually *read* your entire business plan. (They probably will have an associate scrub it, though.) As I commented there,

> Writing the business plan is good discipline for the entrepreneur (and good entrepreneurs frequently have a problem with discipline).
>
> Once you've finished it, you should distill all that skull sweat into a two-page executive summary and stick the plan in a drawer. Your investors may or may not ask to see it. But your exec summary and PowerPoint/Keynote presentation will be better because you wrote it.

If you've done it right, you should have no trouble getting meetings scheduled with venture capitalists. (Really. Trust me. These folks get paid to make investments. If they don't make investments then, eventually, they don't get paid.)

You need to make sure you have scheduled meetings with the *right* venture capitalists, and you may have to buy some plane tickets, but all you have to do is demonstrate your ability to create a business plan that's in the top 10% of your peers, and you'll get meetings.

So, first off, congratulations. You've done a lot of hard work.

Now do more.

Remember the bit about targeting your investors carefully? If not, go read it. Because now that makes a huge difference. You're going to go to a meeting, chewing up valuable time for both you and for the VC... it'd better be a good match.

You already learned a lot about the VC firm before you networked your way into sending them a plan. Now you have to learn more about the *individual(s)*, and the current status of their fund.

Individual

You're not going to go meet with "XYZ Ventures." You're going to meet with Joe Tightpockets, or Sally

Webtragic, or whoever. Find out who else is going to be in the room beforehand. And now the Google Machine is your friend. Learn everything you can about the individuals... where they went to school, where they worked before they became a VC, which deals they've done, which boards they sit on, which non-profits they contribute to, etc. Make some phone calls, explore connections in LinkedIn. Don't worry about feeling like a stalker. Privacy is overrated. 😉

Current status of fund
In the process of ~~stalking~~ researching your ~~prey~~ potential investor, you have found out a lot about his or her firm. A lot of it looks repetitive and deadly dull. But you need to know this stuff.

You can never step in the same river twice. And XYZ Ventures is never the same investment firm twice.

Existing portfolio
They're always adding portfolio companies. That's a two-edged sword for you. VC firms love having synergies between their portfolio companies. That's because we're all trying to emulate the glory days of KPCB and their "keiretsu" investing model. So if you can become a part of the supply chain of an existing XYZ portfolio company -- or vice versa -- you score points. But, if they've already invested in a company that's "too close to your space," you can see their eyes glaze over pretty quickly. Be aware that their definition of "too close" and yours may be very different.

Stage of fund
You don't get a check from "XYZ Ventures." You will get a check from an entity with a name like "XYZ Ventures IV, L.P." I talked about limited partners earlier... they're the ones with the money. As the venture firm goes through the cycle, the general partners raise distinct funds, usually distinguished by Roman numerals. If things are going well, the GPs will be managing multiple overlapping funds... in this example, XYZ Ventures III, IV, and V. There are really good reasons to not allow cross-investments between funds, so you're going to have to match your capital needs to the capital reserves of one of those funds.

Let's say that XYZ Ventures III is ten years old, IV is six years old, and V is two years old (a typical spacing). Fund III is in "harvest mode"... with luck, they've made their numbers with some good IPOs or M&A activity, they're not making any new investments from this fund, and they're reserving any remaining capital for follow-on investments to get the stragglers sold off at any acceptable price. Fund IV is nearing the end of its investment cycle, but there likely some capital still available for new investments. And Fund V is wide open, with lots of uncommitted capital.

So, you would be happy with an investment from either Fund IV or Fund V, right?

Wrong. It depends on your stage of development. If you're raising a Series C round, and you expect that to be the last round of capital you need before IPO or M&A in a couple of years, then you're a good match for Fund IV. In fact, they're probably looking for a few deals just like you, with lower return potential but lower risk, to fill out the portfolio and keep the numbers looking good.

If, on the other hand, you're just starting off with your Series A fundraising, Fund IV would be a *terrible* investor for you. Because in a year or two, you're going to need your Series B... and XYZ Ventures IV will now be in its eighth year, and they will be stingy with capital... and by the time you need your Series C, Fund IV will be shutting down, with the last few deals (you!!!) being herded to the auction block, bleating and mooing.

On the gripping hand (you need three hands in this business), Fund III is hungry for good deals, but they haven't made their numbers yet, so they're still swinging for the fences. If you come to them with a potential base hit, they may look right past you at the next bright shiny object to come their way.

So, you want to raise Series A money from a young fund, of an appropriate size that your returns will be material in making good returns for the overall fund. It may be Roman numeral XIV, but as long as it's only a year or two old, they'll be able to keep investing their *pro rata* in every round until you get profitable, get sold, or get dumped.

It gets confusing, because all of these funds are "XYZ Ventures" and they're all represented by the same set of blue-buttoned-down khaki-clad Stanford MBAs, but it's the sort of thing that you really *don't* want to get surprised with down the line.

Internal industry model.
Remember that you've been doing your homework, so you've probably been able to establish some common threads behind your targeted venture firm. They might have done a bunch of SaaS deals, or maybe they've gotten into open-source. You don't have to *fit* that model, but you have to *understand* it... and explain either how you *do* fit, or how you're a useful counterbalancing bet. If you're not prepared, then the VC can make some stupid sweeping comment like "But all computing is going to move to the cloud, leaving your rich client orphaned" and you wind up gaping like a fish. If you're prepared, you can have an intelligent reply and actually lead the VC into a discussion rather than *ex cathedra* pronouncements.

Why all this homework? It's to prevent you from making an incredibly common, yet incredibly stupid, error.

Let's say you and your team (bring one or two other people... don't go alone, and don't bring a crowd) have a meeting scheduled in the VC's office at 2:00 pm. You're going to be there at 1:50 to allow for getting lost, to scope out the conference room, and to pre-flight the technology. (If you are using a laptop, it should already be booted. If you're using a projector, it should already be powered on with your first slide on the wall. Even if you still use a PC, you might think about getting a Mac for your presentation work to reduce the possibilities of embarrassing fumbling in front of your audience.)

So a pair of associates are on time at 2:00, and your target VC waltzes in at 2:04. You chit-chat for three minutes about the traffic, if you got your parking validated, and yes, the view from the window is spectacular. It's now 2:07 pm. The meeting will end at 3:00. And now you open your mouth and say something suicidally stupid.

"Tell me about XYZ Ventures."

VCs have egos as big as all outdoors; it's in the requirements spec. So he (or she; ego is genderless) will start telling you about XYZ Ventures. Their history, their investment philosophy, their portfolio companies, their IPOs, their value-added service, their limited partners, their special limited partners, their double-secret extra-special limited partners, their entrepreneurs-in-residence, their Ferraris, their yachts... it'll probably take 25 minutes until they have to stop for air.

It's now 2:32 pm. The meeting is still going to end at 3:00. And you have just wasted half of your allotted time listing to this blowhard natter on about information *that is all on their Web page!*

Imagine a different scenario. You have chit-chatted. It's now 2:07 pm. Now you say, "I've done a lot of reading about XYZ Ventures. I know you've invested in three SaaS companies, and that you personally are on the boards of Bloxrog and PurpleGroovy.com. I went to school with Ramit over at Bloxrog, he's a great guy and I know you like working with him. Let me show you how my company can fit just upstream of PurpleGroovy.com, and why we'd love for XYZ to lead our Series A round."

That took fifteen seconds. It's still 2:07 pm, but you now have my full and undivided attention. My Treo stays in its holster, I'm gesturing to my associates to take copious notes, and now you can swing into your 10-20-30 presentation (more on that soon).

It's probably the most common mistake I see entrepreneurs make when raising money: They come armed with a sales pitch for their product. Maybe a good pitch, maybe a bad pitch, but clearly trying to sell their product.

I don't want to buy your product.

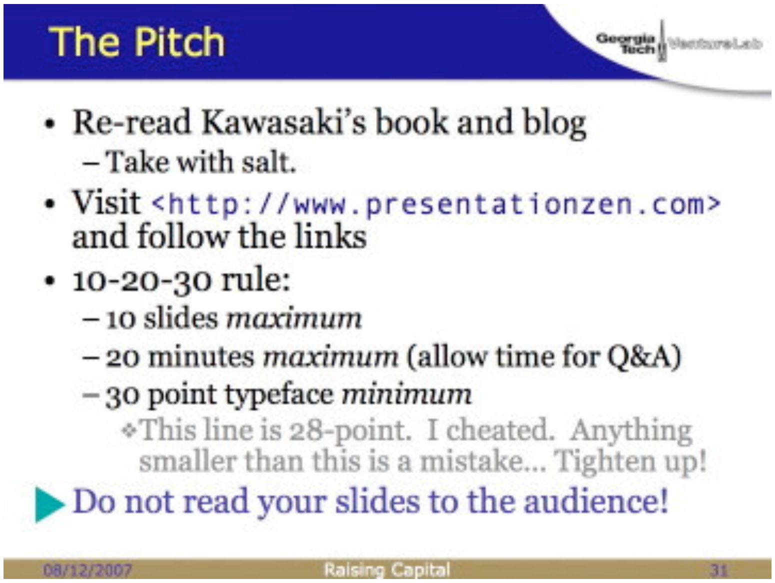
I *might* want to buy part of your company.

That's a different proposition, and requires a different approach. Different slides. Different flow. Different questions to be answered. Just like my saying that the technology can only occupy about 10% of your business plan, the product pitch can only occupy about 10% of your fundraising presentation. (Which means *a single slide* if you're following 10-20-30; more on that below.)

I know, you feel like you're neglecting your baby. Get over it. Because, as I've mentioned before, you need to tell me about your team, your company history, your customers, your revenue, your competitors, your channel strategy, your potential acquirors... you know, all that stuff that might actually make me want to invest in your company! If you spend all your time on your technology, you won't have time to tell me about the rest.

Sell your company--not your product.
Sell your company--not your product.
Sell your company--not your product.

What I tell you three times is true.



Okay, it's time to prepare your presentation. Lord, I can't understand why so many people screw this up.

I've had you read Kawasaki's book once already. Read it again. Take it with salt, since he's primarily an entertainer, but there's good information in there.

If you're not a very experienced presenter--or, heck, even if you are!--go to http://www.presentationzen.com and spend an afternoon following the links and watching the examples. Buy their book. If you are a poor presenter, you can become adequate. If you already a good presenter, you can become very good. If you are Steve Jobs... well, I seriously doubt that you're reading my blog!

Kawasaki maintains his 10-20-30 rule:

- 10 slides maximum
- 20 minutes maximum (allow time for Q&A)
- 30 point typeface minimum

You may not like these rules. You may find these rules silly. You almost certainly *will* find these rules very difficult to follow. Do it anyhow.

If you stuff everything into your business plan into your presentation, you will look like an idiot. (See how often that thread sneaks its way into this discussion? Don't look like an idiot.) Heck, if you simply stuff everything in your *executive summary* into your presentation, you're still just average.

In your fundraising presentation, you are *selling*. You're selling the company, not the product (see above), but it's a sales pitch nonetheless. Treat it that way.

(Refusal to see the presentation as a sales pitch, incidentally, leads to thinking you have to create a presentation that stands on its own. This is the prime cause for the "kitchen sink" syndrome of throwing everything into the PowerPoint/Keynote file. FAIL. If you don't remember why "your PowerPoint deck shouldn't function without you standing in front of it talking," then go re-read Part 08.)

Now, this is where I shout at students.

When I say 30-point type, I mean 30-point type. Or *bigger*.

I used to say "Your text should be legible if you have 35mm slides and you're reviewing them on a light table. Without a loupe." But the young whippersnappers are beginning to stop laughing at me and start looking at me with a puzzled look of non-comprehension. It's like I'm talking about cuneiform or something. Sigh.

So then I started saying "Your slides should be legible on a cellphone screen." But then everybody started getting iPhones with as many pixels as my original Mac, so that doesn't work anymore.

So now I'll stick with the 30-point rule. Or, if you're mathematically inclined, then let me modify Kawasaki's algorithm: "Find out the age of the oldest person in your audience and divide it by 1.5. That's your optimal font size."

You think you have a good reason to break that rule. You have more information than you can convey in type that big. Or you have a data chart that really needs 12-point labels. Or you're pasting in a spreadsheet using OLE (data exchange of the devil) and it's really hard to reformat it. Or you're reusing old slides and don't have time to create new ones.

All of these are weak excuses that make you look lazy, or stupid, or both.

Get it in gear and create new slides (channelling both Tufte and Kawasaki, with a nice dollop of Presentation Zen) that provide a good *backdrop* for you to stand in front of while selling the company. Because the important part of that presentation is *you*. If you're shovelling too much information into the slides, you're embellishing the backdrop, while what you need to be focusing on is *yourself* and the message you convey.

Slides can't do that for you. The slideshow should be a set of reminders for you of what points to hit, in which order, as well as some pretty diagrams or photographs for concepts that deserve them. In fact, once you get good at this, you can reduce your entire presentation to diagrams and photographs, with no words at all.

And then you won't care about type size, because you won't be using any.

(Let me digress here: there is no reason whatsoever to use 90% of the animation options available in PowerPoint or Keynote. In particular, if you use "Laser Type" or "Typewriter" in front of me, I will do my best to accidentally knock your laptop to the floor.)

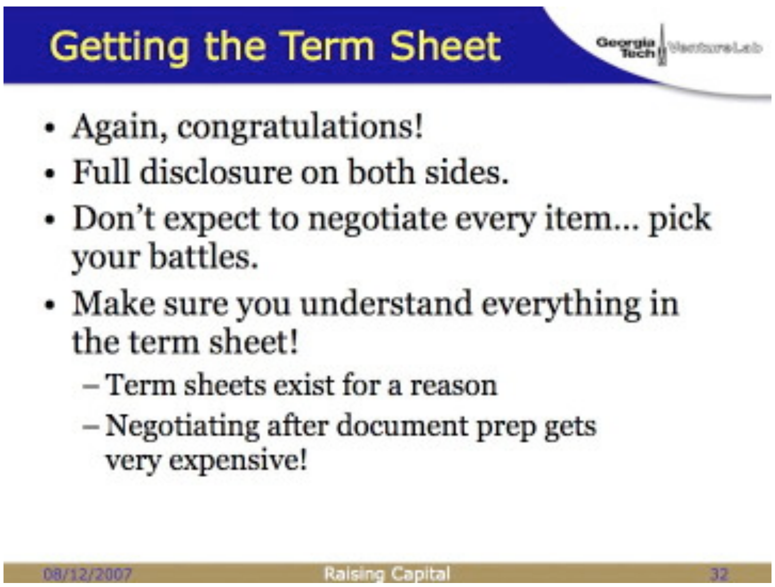
Presentation style: You should plan to speak at a measured pace of about 100 words per minute. Most people read at about 400 words per minute; I manage about 1200. (And, in the world of VCs where everyone scored 1600 on their SATs, I'm only about average.) So if you stand there and read what's on your slides to me, I'm going to finish reading the entire page while you're still on your first bullet. Boredom sets in...

In the *best* case, I'll pull out my Treo and start reading email. At least that's a visible signal that you need to do something to take control of the meeting. In the worst cases, I start thinking about other deals I'm involved in... or other deals I want to do... or why no one wants to buy my Panoz... or whatever. And you'll never know that I'm tuning out 11/12ths of what you say.

Again, the slides should be a *backdrop*. You should tell a compelling story in front of them that makes me pay attention to you, not the screen. In other words, don't be this guy.

One way to tell if you're focusing the attention on yourself is to videotape yourself giving your presentation. This is *painful*. You'll *hate* the way you hum and haw, the way your mannerisms are magnified, the way you lean on the presentation as a crutch. Okay. Then do it again. And again. You *will* get better.

Finally, here's a gedankenexperiment for you: If you walk into the VCs conference room for your scheduled meeting and there is a complete power failure, what are you going to do? (For the smart-asses among you: Assume the conference room is well-lit by windows, and that your laptop battery is dead.) Miss the opportunity? Or pitch without your PowerPoint crutch?



Okay, you've written your business plan and made N pitches (where 'N' is a larger number than you originally expected). If you've done everything right, at some point, the VC will say "We like this deal; we're going to crank out a term sheet."

First off, a little celebration is in order. If you're dealing with ethical VCs, a term sheet is a commitment to invest, *if* you can agree on the terms (that's where the name comes from) and *if* they don't find out anything devastating in the "due diligence" process. (Yep, you knew those old felony convictions would come back to haunt you someday! :-)

So, congratulations. Now, don't screw up.

The basic terms are the ones you would expect: How much money are they paying, for how many shares of stock, and how many board seats. The first two (dollars and shares), together with your existing capital structure, define your company's valuation. The board arrangement defines your governance. Those are always negotiable, within certain limits, and it's *not* amateurish to push back on those. Ditto for liquidation preferences.

(Within certain limits: If they're suggesting that they have three seats on a five-person board, you can suggest that they have two, you and your management team have two, and you'll mutually agree on a fifth from outside. You probably *can't* suggest that they get one seat and you get four. See the difference?)

Beyond the basics, the right way to negotiate a term sheet is to practice full disclosure on both sides. If you hand them material surprises at this point, you might be able to survive; if you wait until after the documents are signed, you're going to sued for rescission.

Note that the VC needs to be reciprocal. The term sheet needs to lay out everything they think they're getting for their investment; this isn't the time to be saying "Oh, we'll work out those details later."

You may be surprised by the number of terms, with titles like "Right of Co-Sale" and "Liquidation Preferences" and "Key Person Insurance." There are a few leading law firms that prepare a significant fraction of the term sheets in circulation, and they all talk to each other. If a particular deal goes bad, there is a scramble to paper over that particular failure mechanism in the term sheet for the *next* deal. Such fixes are cumulative. (This is a process akin to fixing bugs in software, except that you are dealing with self-aware mutating bugs.)

Term sheets originally fit on a single sheet of paper. When I started in the VC business around 1995, term sheets had evolved to about six pages. Now, they run about twelve pages. Every paragraph on those twelve pages represents scar tissue from someone's bad deal somewhere.

One corollary of this situation is that a particular VC firm has evolved to using a particular term sheet template over time, and they're not going to tear it up and go back to a one-page set of terms just for *you*.

You might not like their "Right of First Refusal" on selling your shares. But if your VC (or another VC client sharing the same law firm) has ever had a founder sell out early because they *didn't* have this term (check out the history between CraigsList and eBay), you can bet this will be in their term sheet, and it's not going away.

Pick your battles. Get the valuation and governance right, then go focus on making your company a huge success. Most of those twelve pages are there to protect the VC for deals that go sideways, downwards, or bankrupt. It's amazing how many of the restrictions and negative covenants just disappear for a *successful* company.

Final note: Term sheets exist for a reason. I usually describe term sheets as "12-page documents written in a language remarkably similar to English." These lead to 300-page purchase agreements written in language remarkably *unlike* English... but that 300-page document will be the legally-binding instrument. The right time to learn what all those paragraphs and clauses mean is while you're still looking at 12 pages.

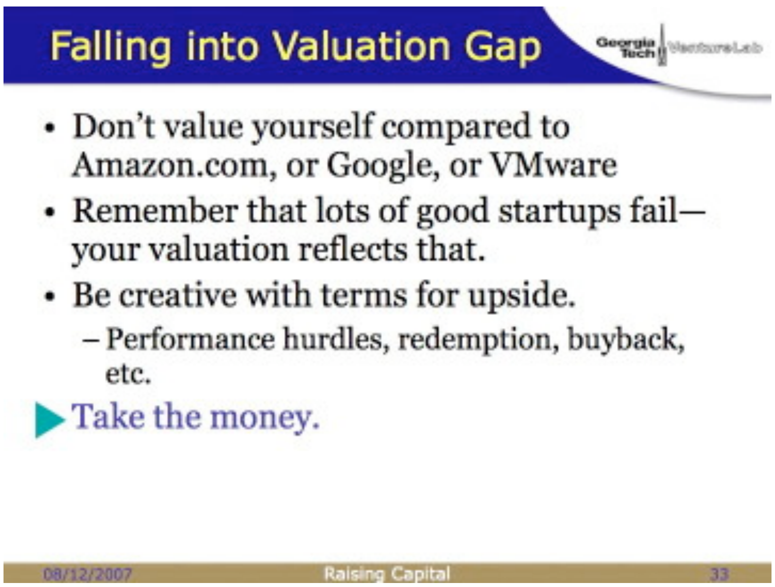
For example, you may see a "Drag-Along Agreement" that reads something like this:

> The holders of the Common Stock and Series A Preferred shall enter into a drag-along agreement whereby if a majority of the holders of Series A Preferred agree to a sale or liquidation of the Company, the holders of the remaining Series A Preferred and Common Stock shall consent to and raise no objections to such sale.

Now, if you want to argue over this (perhaps you want it to be a majority of *all* shareholders voting as-converted, or a 75% supermajority of the Series A, or a majority of the Series A *plus* a majority of the board, or whatever), you're within your rights to try and negotiate it. You may or may not win, but you can have a conversation directly with the VC about it.

If you wait to point out that you don't like that particular form of drag-along until after that single sentence has mutated into two pages of legalese... Now you spin up your $400/hour lawyer, and the VC spins up his or her $500/hour lawyer, and they will merrily go argue at a combined cost of $900/hour. Did I mention that the company (that's you!) pays legal costs?

Brad Feld has done a fabulous job of writing up individual terms here, and I am not sure if I can add any real value to his version. If there are particular questions, put 'em in comments or email and I'll see what I can do.



Entrepreneurs and VCs always disagree on valuation. You think you're worth $20 million, and the VC thinks you're worth $1 million. The right answer is, you're worth what the market will bear. And if the market is bringing the money, you need to listen to what they're saying. (Assuming, of course, that you *need* their money. If you don't, why are you on Part 12 of this series?!??!)

If you've done everything else right (targeting the right VCs, selling your company instead of the product, etc.), then you will have definitively established a market price, because you're in discussions with the right purchasers.

There really isn't a science to valuing a seed-stage company. This drives left-brain types absolutely batty. You try to orchestrate a valuation that leaves everyone with a reasonable piece of the pie... typically, after the Series A, it would be typical to see the VCs with 40% of the company, the founders with 40%, and the employee option pool at 20%. But don't game the system... don't try to raise $5M if you only need $1M, just to value your stake at a higher price. That will get noticed.

You will occasionally see discussions like this one from Michael Blake at Adams Capital:

> If you want to get more technical, I would price a seed stage company using a call option

> pricing model - specifically, the binomial option pricing model. This is how pharmaceutical companies have been pricing R&D projects for years, and we use that model frequently to value intellectual property. And if you think about it, almost all the value in a seed stage company is the IP. And, the binomial option intuitively follows the "all or nothing" nature of venture investments (or you can use trinomial for all, nothing, and mediocre return trajectories if you prefer). For the inputs, take implied volatility of micro-cap public comps (available through Bloomberg) and convert to binomial volatility (there is a formula for this). For time to option expiration, choose a time to exit. For current price, take the expected (hoped) cash flows coming back to the investors, discounted back to today (probably at a rate of around 80%) For the exercise price, take the present value of expected future investments. Of course, you're still at the "problem" of the uncertainty of future cash flows, but the stock volatility and the high discount rates help price in that uncertainty. The result generated by this Cox-Rubenstein model is before discounts for lack of marketability/liquidity (for seed stage companies, at least 50% for seed stage) or lack of control (at least 20%).

And, at the end of the day, you'll still converge on a model where the VCs value you like livestock: $1 million per founder, to a maximum of $3 million.

Here's a hint: Lots of the most onerous terms (high liquidation preferences, etc.) are to protect the VC against downside risk. And, unlike most investments, the downside for VC-funded startups goes all the way down to zero value. That doesn't happen with IBM stock. Or Atlanta municipal bonds. Or REITs.

Putting zeroes in an IRR calculation does terrible things to the VC's reported return rate. They have an absolute necessity to salvage whatever value they can out of bad deals, or even deals that just go sideways for years. And the earlier the stage of your deal, the more likely it is that you will be one of the zeroes dragging down their IRR. That's nothing personal, it's just the nature of the business.

But--and it's a big but--once they reach a certain rate of return, they're able to be magnanimous. This is where you can get creative! For example, you could say: "Okay, I understand that you need to have a 1X liquidation preference. But what if we made it that the liquidation preference ramps down to 0.5X for any M&A proceeds over $50 million, and disappears entirely for anything we get over $100 million?"

They just might bite! And, since the Series B terms are often based on the Series A terms, and the Series C terms are often based on the Series B terms... you have a chance of keeping this particular provision (or modifications to it) throughout your entire venture capital fundraising. That could mean tens of millions of dollars more to the company... meaning the employees, the other founders, and *you*.

And an approach like that puts you in a position of strength. In essence, you're saying "We disagree on valuation. I want you as my investor, so let's accept your valuation... but if I prove that I was right all along, and we get bought for a price that reflects my higher valuation, I want some additional cash in my pocket for that."

Investors like confidence.

My last bit of advice to bring this twelve-part series to an end... Once you've gotten to this point with a Series A investor--and I'm assuming you would not have gotten to this point with an investor who isn't a good match for your company--

Take the money.

Yes, you probably can get a higher valuation from somebody else six months from now. But that's six months of your life on airplanes giving fundraising pitches. That's six months in which you're not back home recruiting a management team and refining a marketing strategy and building strong customer relationships and hammering on the developers to "ship something, dammit!" That's six months in which your invisible unknown competitor--with similar technology and with employees who are just as smart--will be doing all those things, because he or she took the money. And when you finally do take someone's money and launch into the marketplace... you'll find all the low-hanging fruit has been gobbled up by that competitor. Which means you need *more* money to reach higher, and... there's a never-ending spiral there, and it's not pretty.

There's not much value in holding a higher percentage of a company that is worthless.

Take the money.

And go off and start building a great company!

But remember... it's almost time for you to start thinking about Series B...

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