ENTREPRENEURSHIP AND LEAN STARTUP. HITTING THE WALL BUT STILL GOING.

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Venture money

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Two types of businesses. Self-funded healthy company or company on steroids?

There are two possible scenarios of the business development and company creation. You can run the business as a self-funded venture or as a VC backed venture.

On the initial stage business will require the investment anyway. Simply because it is not generating cash initially. So most likely during the early times of start-up business burns cash no matter what. First money business burnt was usually own or 3F money.

As soon as business starts generating revenue it gets the chance of growing organically. You are getting the profit (earn more than spend) and reinvest this profit to grow the business further. That would be the most reasonable and healthy approach. Alternatively, you may want to raise the capital. And go VC funded company's route. There two reasons you may consider VC money:

Your startup requires serious upfront investment (hardware business normally)

You would like to buy the scarcest resource in the world – TIME.

P.S. Less than 1% of startups raising VC money. Just like that. Still care to listen further?

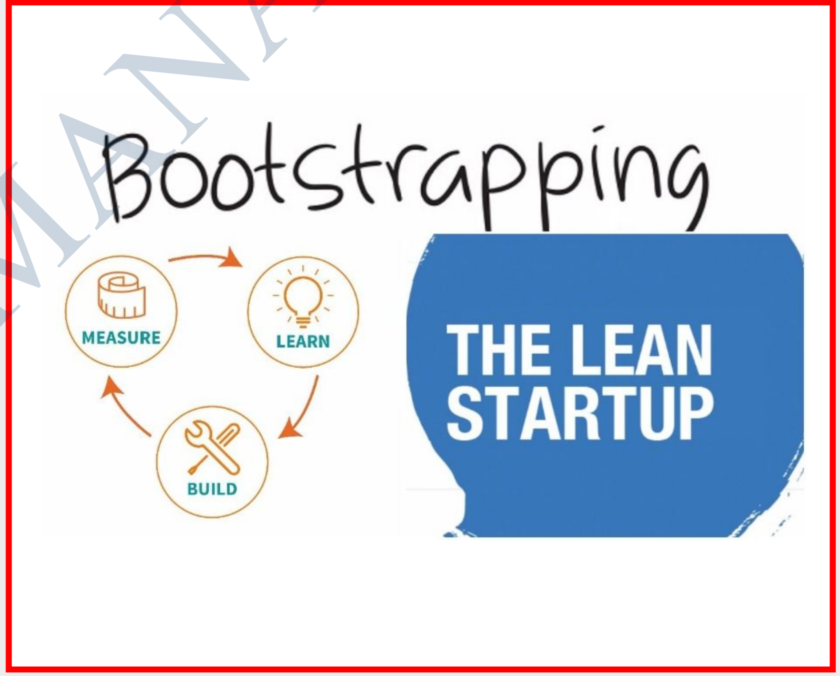
Bootstrapping

Bootstrapping is running business lean minimizing the expenses. Even if you decided to bring over the VCs you may want to do it as late as can. **You have the chance of raising the money on any stage:**

- The idea's stage
- The MVP's stage
- Referenced customers' stage
- Revenue's stage

Obviously the later in this game you are raising VC money the bigger valuation for your company you can get, and consequently you get more money while having less dilution. So even for VC backed company, you will want to bootstrap as long as you can.

Bootstrapping is all about cost control, and it is where Lean Startup approach shines. It is exactly doing more with less.



Why venture money?

If you decided to raise the capital for your venture basically you have **three options:**

- Grants and other "free money."
- Debt capital
- Equity capital

Grants are good as they are free. This option is very limited normally. Your startup should be tailored towards some particular industry, goal and should meet a number of criteria to qualify. The drawback of this approach would be the compliance and excessive monthly reporting to the grand issuing entity or government.

Debt capital would be hard to get for the young startup especially in the technology area. The banks will want pledge, and there is normally none in the tech companies. Also, debt capital requires repayments and comes with an interest. All in all, while debt capital would be the best solution for the fast-growing companies in the later stage when the company requires liquidity but shareholders trying to avoid dilution, this option is rarely available for the early start-ups.

Equity capital is the most traditional option for the tech startups nowadays. Basically, you are giving part of the company for the money your business gets. This type of capital is normally provided by venture or private equity funds. These are willing to take a risk and invest into the company with the hope of enjoying the fast growth of its business and thus seeing the growth of the invested money with some nice multiplicator.

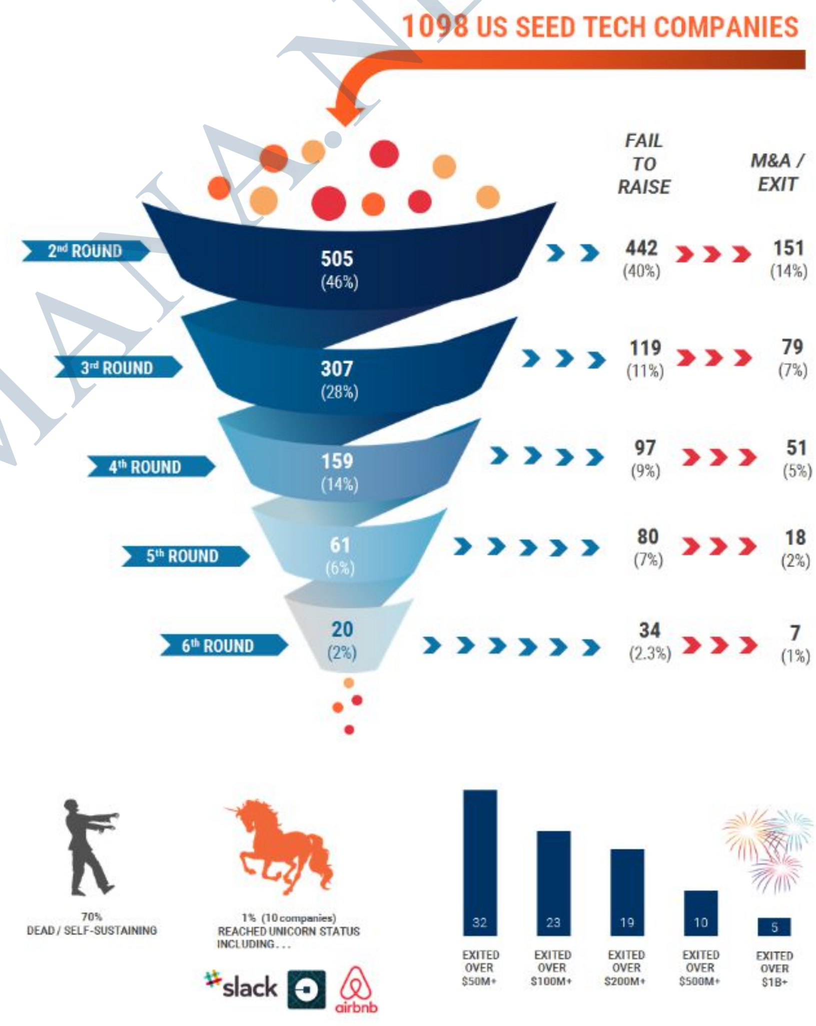
How do venture funds work?

VC fund is a legal entity that accumulates money of the wealthy persons or other funds or entities (Limited partners) with the intention to invest this money into the number of different businesses (type of business is defined by fund's mandate) with the hope that these will grow fast and later will go public or will be acquired, and funds will receive the ROI with the multiplicator. These funds are managed by professional folks (General partners) who apart from the salary have the commission on each successful exit or based on some specific formula yearly.

This type of business considered a risky one. This risk is being balanced by the fact that portfolio consists of several companies. Out of 100 companies in the portfolio 80 will probably end up being broke, 19 will have an exit with 2-3x multiplication and one will be a success with 10x-50x multiplicator and will justify the functioning of the fund.

Is it a Casino? Well, a Casino with the validated learning.

It is not only about the money though. Funds provide extra value to their portfolio companies. This value can be expertise, networking options, PR, and visibility. Here we talk about so-called "smart money."



Note: All numbers based on cohort of companies that raised Seed in 2008, 2009 or 2010 and disclosed valuations only.

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Types of VC rounds

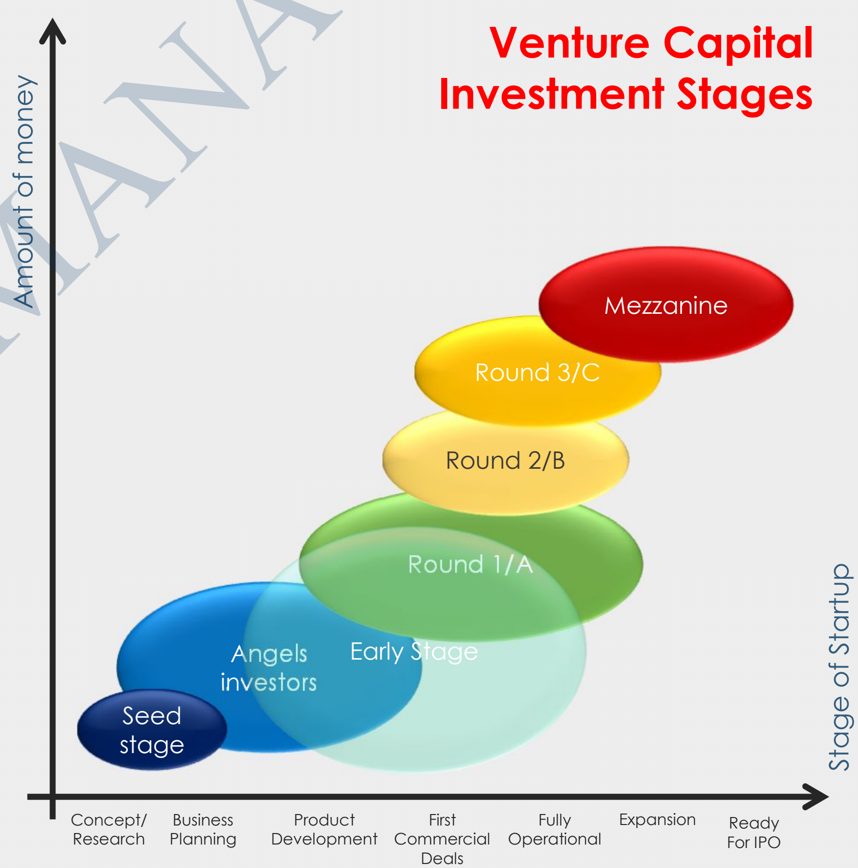
Funds are providing different types of financing for the different purposes. **Several most known:**

Seed round. That would be the initial round from the institutional fund but most likely not the first-time company raises the capital. The first time would be own, angel or 3F investment. Seed round corresponds to the Startup stage in the company's lifecycle. This money will be used for the customer and MVP creation. Sometimes it can be a convertible note. Essentially a loan with the right to convert it into the equity shares later.

Rounds A, B, C, D correspond to the growth phase. Normally tailored toward speeding up the scaling of the business. The company may have all of these or just several, depending on the progress it makes.

Mezzanine rounds. Normally the money taken from the existing investors when there is an exit or next round opportunity, but company runs out of cash presently.

VC money normally provided by the number of funds. Existing funds would encourage the new ones to join the party in the later stages and valuate the company independently.



When may you want to consider venture money?

Consequently, **you may want to consider VC money when**

- you would like to take your business off the ground
- you need to do the pivot
- you found the business model and would like to scale your business
- you are in the middle of the process of arranging an extra VC round or building up the strategic acquisition and need some liquidity to be able to reach that point

These different scenarios would require different amounts of money and, as a result, you would be talking to different types of VC entities. The process time frames and other circumstances would also be different so you can very well say that each and every deal is unique one.

Does it come for free?

Of course, it does not. Nothing in this world comes for free. "Free lunch" means it is free for you. But somebody already paid for it. Now try to guess why somebody may want to pay for your lunch?

You give the share of the ownership of your company for this money. You also give part of the control.

Now sometimes giving away the part of your business is a rational decision. After all, it is better to have 1% from Facebook than 100% of that grocery store down the street. In pure mathematics, 10% of the company worth $1M is the same as 100% of the company worth $100k. So, if you have the opportunity to grow the company fast, you may be better off scarifying part of the ownership. But then again logic and mathematic of the above example suggests that the company should grow faster than in the example for you to earn. Like it should be worth $1,5m for your share to be worth $150k which is more than $100k. Plus do not forget about the time value of money.

Giving away some control can also be a good thing. You will learn the discipline and have more responsibility. Then again funds may effectively destroy your business. For instance, they may want to sell it or block the selling etc.

So, VC money doesn't come for free. It brings a lot of new considerations, to say the least.

Your equity is your blood

The phrase sounds like **"Your equity is your blood. You do not want to lose too much of it."** These funny numbers: **75%** of the shares, **25%** of the shares.

Sometimes they don't have any meaning. Particularly when things don't work out really well. But sometimes each single percent has the value of $1m or more. Or sometimes they can influence your ability to make that or another decision.

Funds normally (especially on the early stages) will be interested in leaving you as much ownership as they reasonably can. After all, the founder without the stock is just a hired manager, and as long as his contribution is crucial to the business, nobody will want to demotivate him. On the later stages though no one will care.

Don't forget about the reserved pool of shares for the critical employees the other shares leakages scenarios.

Don't end up with the successful exit where you will not be the part of the celebration.

You want to raise. What kind of a journey are you about to start?

"Raising VC money is a full-time job." A popular phrase that suggests that this journey presumes a lot of activities. That's why the team of founders is always better than a one-man show. After all, while one founder raises the money another runs the business. The average time mediane for the raising of VC money is six months. **You can divide the process into these stages:**

- Preparation
- Pitching
- Negotiations
- Term-sheet
- Due-diligence
- Negotiations
- Closing
- Post-closing activities

Preparation. You are preparing the deck (presentation), the data-room, the list of target VCs.

Pitching. The endless series of the phone/skype or real-life meetings where you present the company.

Negotiations. Discussing the terms of the potential investment with the potentially interested parties.

Term-sheet. The signing of the preliminary agreement that confirms INTENTION of the fund to invest in your company.

Due-diligence. The audit of your business. Normally they bring the third-party auditing company.

Negotiations. Final tuning of the terms based on the results of the due-diligence.

Signing of the agreements (SHA, deeds, warranties, etc. etc.)

Whatever actions that were parts of the agreement (if any)

How to approach VCs?

You can do it yourself or hire a consultant/adviser. Basically, for the early stages startups and unless the company is worth hundreds of millions and has very complicated ownership structure you shouldn't hire a VC banker. Funds say: "if you cannot raise the money how can you build the company?" So, it will be your responsibility.

There are some opportunities for you:

- Gather the contacts of the funds from the open sources
- Use your network of the contacts

Of course, using the network would be a preferable way as you may get a chance to talk to a decision maker or influencers and that would be a different level of communication. If you don't have such a luxury, then you have no choice but create the Excel file with the contacts of the clerks and start talking to them.

The roadshow and events where you can see a number of managers of the funds as an option would be great though difficult unless you are in the Valley.

Company valuation

The valuation of a private company is a little bit of an art. If we were talking about the public company it would be fairly easy because the shares of such a company are publicly traded on the stock exchange and we always know exact price of the share and can calculate the actual variation of the company. It is different for private companies though. The actual price of the private company is matter of negotiations between seller and buyer or if we are talking about young startup between founders and investors. Basically, private company costs as much as buyer or for that for that matter investor is willing to give for it. It is much easier to assess the business on the later stages when company generates revenue. Knowing multiplicator for some particular industry we can just take the revenue multiply it by this number and have the valuation. For the company that doesn't generate revenue yet it is much more difficult.

You will be assessing

- the value of the idea
- the potential of the company
- the potential of the Market Place
- the results of rivals that achieved something in the industry etch.

If we are talking about selling the business on the later stages then the potential acquirer will be assessing

- The revenue company generates
- the intellectual property company owns: technology code etc.
- the number of customers in company's database
- whether the company's business is in line with the overall strategy of the acquirer

Now the combination of these will be giving the final price, yet again the price of the private company depends on the need of the buyer to buy it and need of the seller to sell it.

Your pitch, your deck

That's the content you will be approaching the funds with. It is a crucial part of the process. You should spend a reasonable amount of time polishing this document. The worst outcome would be having the prospect asking you "so what you are guys doing?" right after having them listened to you.

There are several theoretical frameworks to your pitch, Say Golden Circle.

- **Why?**
- **How?**
- **What?**

These are the main questions your deck should be answering. But getting closer to the earth, these are the questions the deck addresses:

- Who is your customer?
- What problem for them do you resolve?
- What is the size of your marketplace?
- Who are you competing with?
- Why are you better/different?
- Who you are and who are the members of your team?
- What is it you want from us and what we get in return?
- Where are you going to spend the money?
- What result do you plan to achieve?

The good deck will answer these question in some **10-15 slides.** The good deck will have a clear design, a good deal of visualization and maybe some "purple cow" inside. You can find excellent examples of the decks from the leading companies online on the sites like http://bestpitchdecks.com/

Negotiations

Congratulations if you made it that far. Here you are discussing the terms of the investment. **Three main questions are:**

- The valuation of the business
- The share you are willing to sell
- Next steps. What will you achieve with the money?

General advice would be to have your position and protected it firmly. It is very difficult to be firm with VCs, because you need their money more than they need your business (normally) but you need to fight. It is good to define your bottom line internally and then negotiate. You know the condition where you will just go away, so everything better than that is acceptable. There you go and negotiate. You should be firm, reasonable and PURPLE.

And as always listen more than talk. Talking too much worsens your positions. Don't bargain with yourself!

A term sheet

A term sheet is a document that demonstrates their intention to invest in your business and outlines the conditions that can make this investment possible. It is not a final document by all means. Your chances to close the deal after you have term-sheet in place would be roughly **20%.**

Nevertheless, term-sheet is very important. You won't have an option to renegotiate the conditions that were agreed upon in the term-sheet. So, the latter should only include the provisions you are comfortable with. The general rule – the resulting document can worsen your positions but very seldom improve them.

Due-diligence

Due-diligence is the process of auditing of your company. **Two critical components of the due-diligence are:**

- Financial audit
- IP flow audit

Auditing of the finances addresses two concerns:

- The possible negative implications from the state and governing authorities
- The accuracy of the finances and absence of any transactions that lack a business purpose (fraud)

The IP flow audit should clearly demonstrate that the IP belongs to the company and one can see the transition of the IP ownership rights from the IP producers to the company.

The above suggests that we need to have the financials and employment/consulting contracts in place and in a good shape.

The rest: legal structure, internal policies, processes are though still subject to the audit are of somewhat lesser importance.

Paperwork

If you have passed the audit successfully the paperwork will begin. We are talking about dozens of documents some of which may exceed 100 pages. The devil is in details, so you will need a corporate lawyer who will review and prepare the documents acting as your representative. Unfortunately, there is no way you can avoid these legal costs because any errors or unclarity in the legal papers may result in serious problems in the future.

Since investors will be represented by the lawyers also, the whole process will be a series of the rounds where both parties will be reviewing the documents and making the changes and then discuss these over the phone.

Remember that **funds aren't in a hurry**. In contrary, they prefer to sign the documents as late as possible. You see, during these 6-9 months they keep a close eye on your business and if something goes wrong they may turn down the deal even one day before the signature, leaving you with the bunch of debts to the lawyers. The important implication: don't act as if you were having the money already until you have the money already.

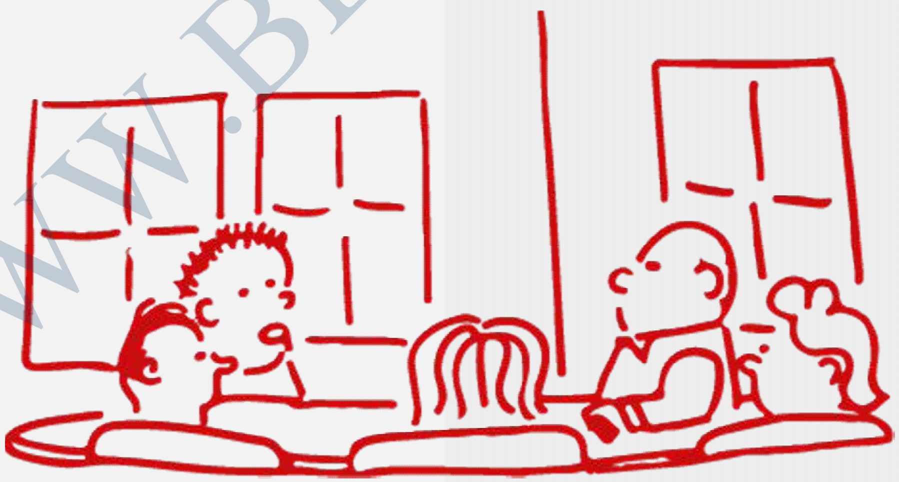
Your new role, if they kept you

Congratulations! You are now the founder of the VC backed company. Your level of responsibility will increase now and so will your level of stress. You are the founder but are you CEO? It depends. If it is your first startup and you don't have a proven track of achievements nor the name in the industry they may withdraw you from the position of the CEO. Or they can keep you.

If they withdraw you then again there are two scenarios. One is you are still with the company but in a different position.

Normally happens to the technical founders. A lot of grounds for COI now. Beware. Or.. be gone. If you lost your employment with the company even though kept the ownership, you are free to pursue whatever other opportunities you have. If the round happened with some part of "cash-out," you even made that "MINI-EXIT."

If you are a CEO. Congratulations. Apart from your (huge) list of the responsibilities you will be managing the board and investors relationship from now on.



Running BODs and managing them

These people can be your allies or your enemies. That will largely depend on your behavior. Always remember, you will need the support of these people to make that or an another decision of yours a reality. Sometimes you will be asking these people for more money. People don't like when you keep them in the dark and only coming to ask for help or money. In contrary, to be able to come and ask for that help one day, make sure you have built the perfect communication line with them.

Your responsibility will be:

Running quarterly (or otherwise scheduled) BODs

Reporting the results

Getting an approval for whatever strategic planes or M&A opportunities

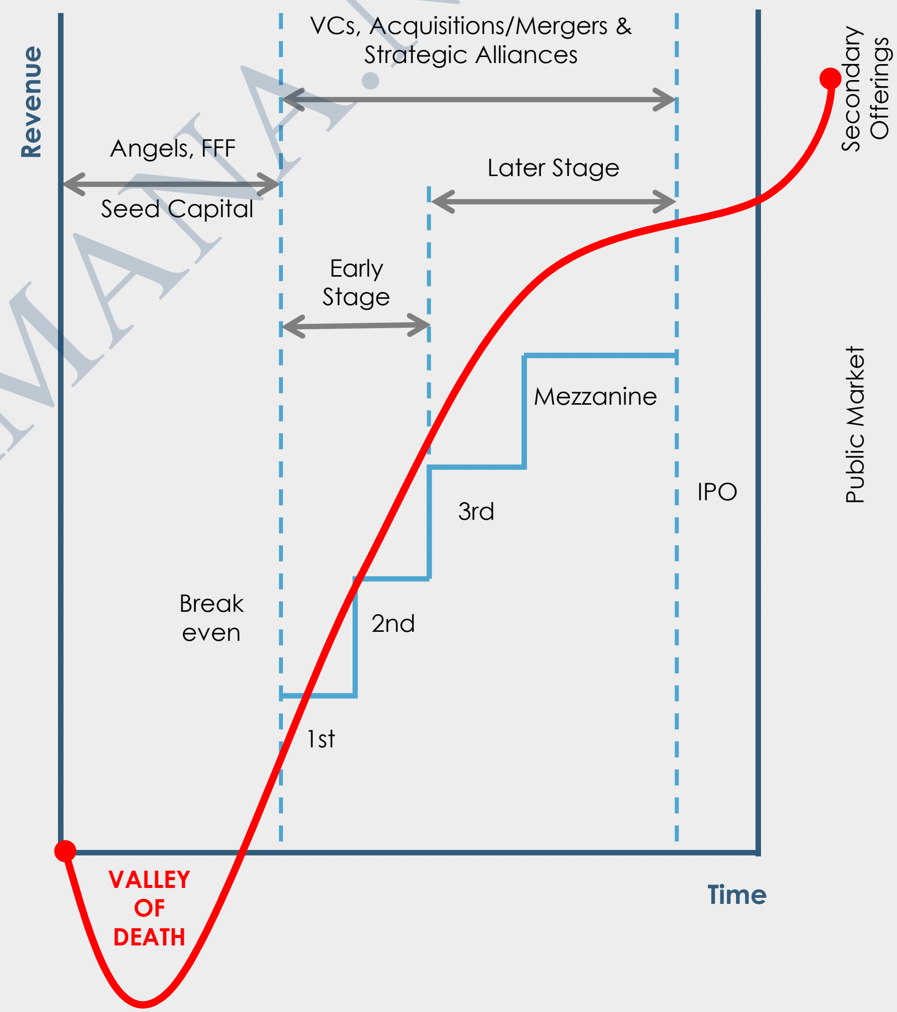
But apart from that it always helps to share some nice PR with them, inform them beforehand about the problems the business faces or have a risk to face. Good working relations always pay back.

More heroin, please

As we know, cash is the king, and CEO/founder should always make sure the company has enough liquidity for the future operations. With VC money, there is always a temptation to close the holes in P&L with the next round. It may work or may not.

The much better approach would be to care about the bottom-line, to reach the profitability point and to get the next round only if/when you clearly know that this funding will help triple the growth and reach the objective much faster.

If you are building the business otherwise, you have the risk of not being able to raise when you need it. That results in bankruptcy. Not being VC money addicted is a healthier approach.



About lecturer

Art Berman, MBA

Art Berman is a successful serial entrepreneur who has founded a number of companies in the technology industry. Mr. Berman brings more than a decade of entrepreneurial experience building and advising successful software companies. Art has managed worldwide online sales and operations since 2003. Mr. Berman earned his Bachelor degree in Economics from Moscow International Business Institute in 1997 and Executive MBA in Edinburgh Business School - Heriott-Watt University in 2014.

Thank you!

Questions