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An Engineer's guide to Stock Options • Alex MacCaw
blog.alexmaccaw.com

December 10, 2013

There's a lot of fear, uncertainty and doubt when it comes to stock options, and I'd like to try and clear some of that up today. As an engineer, you may be more interested in getting on with your job than compensation. However, if you're working at a fast growing startup, with a little luck and the right planning you can walk away from a liquidity event with a significant amount of money.

On the other hand I have friends who have literally lost out on millions of dollars because the process of exercising stock options was so complicated, opaque and expensive. Believe me, you'll be kicking yourself if this happens to you, so why not arm yourself with some knowledge and make informed decisions.

This guide is an attempt to correct some of the imbalance in information between companies and employees, and explain in plain English the whole stock option process.

Shares 101

I like thinking about shares as a virtual currency. Shareholders are speculating on that currency, and the company is trying to increase its value. Companies can inflate or deflate this currency depending on their performance, perceived potential or by issuing new shares.

When companies are formed, they typically issue around 10 million shares. These are split between members of the founding team and are diluted in subsequent investment rounds. A portion of these shares are put aside into an option pool, a group of shares dedicated for employees. Any shares you receive will probably come out of this pool.

Stock Options

When you join a company, you probably won't receive any shares though, but rather the *option* to buy shares. This is a contract which states you have the 'option' to buy shares at a specific price.

You can think of a stock option as a Future. The company is basically saying: "Here's our current valuation. We hope it'll go up. In a year or so, once you've worked at the company for a while, we'll give you the option to buy shares in the company at the price when you joined, even if our valuation has subsequently increased."

Vesting schedules

Option agreements typically have a four-year vesting schedule, with a one year cliff. In plain English this means that you will receive all your stock options over a period of four years, but if you leave in less than a year (or are fired) then you won't receive any options at all.

The 'cliff' is included to incentivize employees to stay at least a year, and to protect the company's

shareholders if the founders decide that you're not a good fit.

Typically you see your shares broken up into 1/48ths. You get 12/48 at your 1 year mark, and each month after that you'll vest another 1/48.

Exercising

Once you've *cliffed*, you have the right to buy shares in the company. There are few ways in which you can benefit from this right:

- **Acquisition:** Hope that the company is acquired and the shares are sold at a large multiple of the exercise price in your option agreement. Investors pay a premium and their shares are *preferred* for a reason — if the company is sold for less than the value placed on it at the last round of investment, your shares will probably be worth next to nothing.
- **Secondary market:** Stock option agreements usually give the company a *right of first refusal*. This means that you cannot sell the shares to a third party without giving the company the opportunity to buy them first. However, once a company reaches a certain stage, the board may allow you to sell your shares through an exchange like Second Market or some other mechanism. At this stage you can cash-out by selling your vested shares to outside investors.
- **Cashless exercise:** In the event of an IPO, you can work with a broker to exercise all of your vested options and immediately selling a portion of them into the public market. This means you can afford both the shares, and the tax without having to invest money yourself.
- **Exercise before leaving:** You can write your company a check and pay any taxes due — in return, you'll get a stock certificate and become a shareholder in the company. You can carry on working at the company (and exercise more shares as they vest) or leave whenever you want.
- **Exercise after leaving:** You leave the company, and send a check for all your vested shares before 90 days is up. This, combined with a cashless exercise, are probably the two most common scenarios.

Each route has different tax implications that can depend on the timing of the sale and the amounts involved. As a general rule, if the company you're working for is growing like crazy (and you think it might go public someday) it makes a lot of sense to exercise your right to become a shareholder as soon as possible.

Depending on your personal financial situation, the number of options granted to you, their exercise price, and their change in value, exercising the right to buy all of your vested shares may be prohibitively expensive.

Even if you have the cash, you may not want to spend your life savings on a stock certificate and a tax bill. The earlier you joined the company, the cheaper these shares will have been. If the value of those shares have increased considerably there will be signifiant tax liabilities. Furthermore you'll probably only make money on the investment if there's a liquidity event. This is why early employees at fast-growing startups essentially have a pair of *golden handcuffs* on and cannot leave — they're paper millionaires but they're not able to exercise their right to buy the shares and therefore have to stick around until the company is sold or goes public.

If you decide that you want to leave (and you think the company has a great future ahead) you typically have about 90 days to decide whether you want to exercise your vested shares and come up with the cash to buy the shares and the associated taxes. If you can't afford to exercise, or decide not take the risk, then the option expires.

Questions you should ask going in

When you join a company, there are some important questions you should ask:

- How many shares will I have the option to exercise?
- How many shares are there in outstanding? (or what is the total number of shares?)
- What is the exercise price per share? (Or what price can I buy them for?)
- What is the preferred share price? (Or what have investors paid for their shares)?
- What does my vesting schedule look like?

These questions will let you figure what it would cost to buy the shares and the current valuation of the company. Crucially, you'll be able to calculate the percentage of the company your shares would represent if they were all vested today. As a company grows and issues more shares this percentage will decrease as your shares are diluted. Nevertheless, it's still good to have a rough idea of the percentage of the company you own when you start.

Don't be deceived if you're offered a large number of shares without any mention of the number of shares currently outstanding. Many companies are reluctant to share this kind of information and claim it's confidential.

If the company seems reluctant to answer these questions, keep pressing and don't take 'no' for an answer. If you're going to factor in your options into any compensation considerations, you deserve to know what percentage of the company you're getting, and its value.

I'd be wary of compromising on salary for shares, unless you're one of the first few employees or founders. It's often a red flag if the founders are willing to give up a large percentage of their company when they could otherwise afford to pay you. Sometimes you can negotiate a tiered offer, and decide what ratio of salary to equity is right for you.

Likewise, I'd take into consideration the likelihood of an IPO when estimating how valuable your options are. Companies such as small consultancies or lifestyle businesses may offer you shares, but a return is unlikely. Having a small slice of ownership may feel good, but may ultimately be worthless. If the company has been around for a few years without a clear upward trajectory, an IPO is probably unlikely.

Other questions

There are some other questions you should ask, but may have a harder time getting a straight answer:

- How many shares is the company authorized to issue?
- Have any shares been issued with a liquidation preference greater than 1x?

The answers to these questions could affect any returns. For example, if the company dilutes the stock pool, then the value of your shares will decrease. Additionally, if some investors have a preferred liquidation preference, then they have the right to cash out first if there's a liquidity event.

Example scenario #1

Let's say the company gives you the option to buy 100,000 shares at an exercise price (or strike price) of $0.50 per share. If the company has 10,000,000 shares outstanding, then you have the option to buy 1% of the company when fully vested. It also means the current valuation of the company is five million dollars.

Let's say you leave the company after the first year, meaning you have only vested 25,000 shares (100,000 / 4), which will cost you $12,500 USD to purchase. This is a highly simplified example which doesn't include any tax liabilities, but it gives you the general idea.

409A valuations & tax

A 409A valuation is a fair market valuation of a company as determined by an accountant and is reported to the IRS. This valuation is often lower than the valuation at the last investment round because investors are more optimistic about the company's future, and are speculating on its potential. As a company approaches an IPO, the delta between these two valuations will shrink and eventually disappear.

By comparing the company's 409A valuation when you were granted the options and the 409A valuation when you purchase the stock, you can get a good indication of your tax liabilities. If you've only been at the company for a year (or the company hasn't grown materially) the 409A valuation may not have changed, and if you decide to buy shares you'll have no tax liability.

However, if the difference is significant, the IRS will treat this gain as an "AMT preference", and tax you on the spread. The tax bill can often be greater than the check you have to write to your company. You have to pay real money for gains that only exist on paper. What's more, if the company fails then you don't get the tax refunded – only credits towards your next tax return. This can substantially increase the risk on the investment.

The last thing worth mentioning here is that if you're buying vested shares before you leave the company, than I strongly suggest you look into filing a "83(b) election", which could significantly decrease the amount of tax you have to pay. A full explanation of 83(b) elections is a guide in itself, but essentially they let you pay all your tax liabilities for both vested and un-vested stock early, at the current 409A valuation (even if the valuation subsequently increases).

Things you should know going out

If you're thinking about leaving and you haven't bought any shares, you should decide whether or not you'd like to become a shareholder. If you think the company's going to be wildly successful, then it might be worth the risk. Assuming you decide to go ahead and purchase the stock, you have three months to give the company a check.

Ideally, you should know the following:

- How many shares have been issued
- The current 409A valuation
- Preferred share price of the last round

It's much easier to find out the answers to these questions when you're still at the company, so I suggest you get this information before you leave if at all possible.

Example scenario #2

You've left the company after a year and decided that you want to become a shareholder. Your option to buy the shares will expire 90 days after you've stopped working at the company, so you have to get the money together and give the company a check before that date. You know that the 409A valuation has increased from $0.50 a share to $5. Since you have the option to buy 25,000 shares (you vested a quarter of your 100,000 shares), this is going to cost you $12,500 to purchase.

However, since the 409A valuation of the company has increased to $5, the IRS will see the current valuation of your stock as $125,000, and you'll have to report a gain of $112,500 ($125,000 - $12,500). As income, this will be taxed at around 40% (~20% federal, ~20% state). Obviously this tax level will vary vastly between individuals, but let's just take 40% for arguments sake.

So your total cost to exercise is $12,500 to the company, and $45,000 to the government for a total of 25,000 shares.

Financing options

If you can't afford to exercise your right to buy your vested shares (or don't want to take the risk) then there's no need to despair – there are still alternatives. There are a few funds and a number of angel investors who will front you all the cash to purchase the shares and cover all of your tax liabilities. You hold the shares in your name and if there's a liquidity event you distribute a percentage of the profits to them. They'll typically ask for somewhere between 20-50% of the upside depending on the company, the taxes, and the size of the investment. It's an interest-free loan without a personal guarantee. If the company fails, you don't owe anyone anything; if it succeeds, you'll be rewarded for the value you created whilst working there.

If you're interested in learning more about financing your stock options then send me an email and I'll make some introductions. I've set up an informal mailing list, and have a group of angel investors subscribed who do these kinds of deals all the time.

Conclusion

The reason why I wrote this guide is that engineers are often the unsung heroes at startups, and they too deserve to benefit from the upside in any value they create. It's also why I'm excited about stock option financing, which serves to level the playing field a bit and make exercising affordable, whilst removing the risk for the engineer.

Thanks to Richard Burton, Colin Regan, Adam Fraser, Josh Buckley, Kip Kaehler, Tim O'Shea, and Andrew McCalister for helping with drafts of this article. If you have questions or feedback, then feel free to email me.

As with all information on the internet, take this with a pinch of salt and get advice from a professional CPA before making any decisions. None of this article is to be construed as legal or financial advice.

2,673
Kudos

2,673
Kudos

Killing a library

A programming library's main mission should be to make itself redundant, and with that in mind that I'm announcing the deprecation of Juggernaut. Juggernaut was one of the first solutions to pushing data in realtime to… Continue →

Don't Give Away Your Board Seats | Steve Blank
steveblank.com

Posted on July 9, 2013 by steveblank

I had a group of ex-students out to the ranch who were puzzling over a dilemma – they've been working hard on their startup, were close at finding product/market fit and had been approached by Oren, a potential angel investor. Oren had been investing since he left Google four years ago and was

insisting on not only a board seat, but he wanted to be chairman of the board. The team wasn't sure what to do.

I listened for a while as they went back and forth about whether he should be chairman. Then I asked, "Why should he even be on your board at all?" I got looks of confusion and then they said, "We thought all investors get a board seat. At least that's what Oren told us."

Uh oh. Red flags just appeared in front of my eyes. I realized it was time for the board of directors versus advisors talk.

Roles for Financial Investors

I pointed out that there are four roles a financial investor can take in your company: a board member, a board observer (a non-voting attendee of board meetings,) an advisory board member, or no active role. I explained that as a non-public company there was no legal requirement for any investor to have a board seat. Period. That said, professional venture capital firms that lead a Series investment round usually make their investment contingent on a board seat. And it sounded like if successful, their startup was going to need additional funding past an angel round to scale.

In the last few years, it's become more common for angel investors to ask for a board seat, but I suggested they really want to think hard about whether that's something they need to do now.

"But how do we get the advice we need? We're getting to the point that we have lots of questions about strategic choices and relationships. Isn't that what a board is for? That's what we learned in business school."

What's a board for?

I realized that while my students had been through the theory it was time for some practice. So I told them, "At the end of the day your board is not your friend. You may like them and they might like you, but they have a fiduciary duty to the shareholders, not the founders. (And they have a fiduciary responsibility to their own limited partners.) That means the board is your boss, and they have an obligation to optimize results for the company. You may be the ex-employees one day if they think you're holding the company back."

I let that sink it for a bit and then asked, "How long have you worked with Oren?"

I kind of expected the answer, but still was a bit disappointed. "Well we met him twice, once over coffee and then over lunch."

"You want to think hard about appointing someone to be your boss just because they're going to write you what in the scheme of things will be a small check."

Now they looked really confused. "But we need people with great advice who we can help us with our next moves."

Advisory Board

"Do you know what an advisory board is?" I asked. From the look on their faces, I realized they didn't so I continued, "Advisors are just like they sound. They provide advice, introductions, investment, and visual theater – (proof that you can attract A+ talent.) An advisor that provides a combination of at least two of these is useful."

A "board" of advisors is not a formal legal entity like a board of directors. That means that they can't fire you or have any control of your company. While some founders like to meet their advisors in quarterly advisory board meetings, most companies don't really have their advisory board meet as group. You can connect with them with them on an "as needed" basis. While you traditionally compensate advisors by giving them stock, I suggest you ask them to match any grant with an equal investment in the company – so they have "skin in the game."

Equally important is that an advisory board is a great farm team for potential outside board members. It allows you to work with them over an extended period of time and see the quality of their advice and how it's delivered. If they are world-class contributors, when you raise a Series A round and you need to bring in an outside board member, picking someone you've worked with on your advisory board is ideal."

Finally I suggested that Oren's request to be chairman of a five-person startup seemed to be coming

from someone looking to upgrade their resume, not to optimize their startup.

No Outsiders Until a Series A

As we wrapped up, I offered that there was no "right answer" (see Brad Feld's post) but they should think about their board strategy as a balance between the amount of control given to outsiders versus the great advice outsiders can bring. I suggested that if they could pull it off they might want to consider keeping the board to the two founders for now, surrounded by great advisors which may include their seed investors. Then when they got a Series A, they'll probably add one or two professional VC's on the board with one great advisor as an outside board member.

As they left they were going through the experienced execs they knew who they were going to take out for coffee.

Lessons Learned

- Your board of directors is your boss
- Your advisory board is your friend
- Not all investors get board seats, it's your choice
- Date advisors, marry board members

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See the Video

Lifelock Rings Bell At NYSE

BVP portfolio company, LifeLock, visited the New York Stock Exchange (NYSE) to celebrate the company's initial public offering on October 3, 2012. LifeLock began trading today on the NYSE under the ticker symbol "LOCK". In honor of the occasion Chairman of the Board and CEO Todd Davis, joined by members of the company's executive management team and BVP's own David Cowan, rang today's NYSE Opening Bell….
Lifelock Rings Bell At NYSE

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Twitch CEO Emmett Shear Talks About The Company And Its Success
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CEO Rick Stollmeyer discusses the challenge of selling Saas software to the beauty, health and wellness industry
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by the numbers

103
years old
110
IPOs
$1.6B
current fund
45
investment professionals
$7,500
smallest investment

$66M
 largest investment
2.6
 investing rounds per company
26%
 of the time we lose our entire investment
251
 collective years of investing experience
40
 years held longest investment
4
 most times we backed one entrepreneur
35
 first time CEOs in portfolio
7
 Offices worldwide
12
 Countries home to BVP portfolio companies
36%
 of current capital invested outside the US
1.2M
 miles flown this year
20,675
 yearly phone minutes per team member
78%
 iphone
14%
 Android
8%
 Blackberry
4,380
 startups introduced to BVP annually
11,250
 meals per year with entrepreneurs
7
 times we passed on FedEx
1
 time we invested in a simulcast bullfight
32,597
 annual emails sent per team member
18.3
 terabytes of total data storage
365
 gigabytes of storage per investor
8.3%
 annual data growth

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How we got a Y Combinator interview but blew it

October 24th, 2012

Six months ago, I got a scratchy cell phone call from Tyler while he was hiking at Arches National Park:

"We're going to Mountain View!" he exclaimed.

"What?" I asked, scared I had misheard him.

"Y Combinator said 'yes' for our interview!" Tyler clarified.

"Woohoo!"

A week later, we were in Mountain View. We interviewed in the afternoon, and in the evening we were rejected. Here's how we got to that point.

Note that I have not titled this "How to get a Y Combinator interview" — that's a different problem. This post is simply about what we did. If you want a proper guide, I suggest Jason Shen's Unofficial Y Combinator Guidebook.

> *Y Combinator Funding Application Summer 2012*
> *Company name:*
> Snaposit

It started one evening in early February 2012, when Tyler pitched an idea to me: "Backup for photographers."

Since we both dabbled in photography, that seemed like a real problem, and after some cursory research, we felt we could solve it.

The gist was that photographers generate so much data that it's impractical to do backups over consumer internet connections. We polled some of our photographer friends: Did they currently have an off-site backup solution? Would they pay to have that problem solved? Encouraged by the responses, we pushed forward with our solution: Snaposit.

> *What is your company going to make?*
> Offsite backup service for photographers

We decided that our first deadline for Snaposit would be the Techstars Boulder application. Both Tyler and I lived in Denver, so it was an obvious choice. The early application due date was February 26th, so we filled out the TS application form, spent too long over-producing an application video (which was viewed precisely zero times by Techstars), and sent it in. Fairly quickly, we got a question back from Nicole Glaros of Techstars: when would a prototype be ready?

It was a good question, because it prompted us to actually build the prototype. In a mad dash, we put something together in just a few days. The result was horribly ugly and barely functional, but with the clock ticking, we sent it along anyway. Unfortunately, it was Windows-only, and Nicole seemed to have a Mac. Oops.

> *For each founder, please list [various biographical info]:*
> tghw; Tyler G. Hicks-Wright; 2007, Stanford University, MS, Computer Science (Artificial Intelligence); 2005, Rose-Hulman Institute of Technology, BS, Computer Science & Economics (Double Major); Homepage: tghw.com *[portions redacted]*
> teuobk; Jeff Keacher; 2009, Stanford University, MS, Management Science & Engineering; 2004, Rose-Hulman Institute of Technology, BS, Electrical Engineering; Homepage: keacher.com *[portions redacted]*

Needless to say, we got rejected by Techstars. We laughed it off, called it nothing more than a practice run, and buckled down so that we'd have a really good prototype to show to Y Combinator.

> *Why did you pick this idea to work on? Do you have domain expertise in this area? How do you know people need what you're making?*
> We are both avid, published photographers, with huge photo libraries that we have not been able to reliably back up off-site. We are friends with and have worked with other professional photographers who have expressed that they have the same problem.

As the summer Y Combinator application deadline loomed, we filled out that application and made another video.

Oh, the video. We spent a lot of time on the video, which we justified by thinking that a crummy video made by people claiming to know photography probably wouldn't be very credible. I'm not sure that it mattered in the end, but nobody could argue that our production values weren't high.

> *Please tell us about an interesting project, preferably outside of class or work, that two or more of you created together. Include urls if possible.*
> How about an adventure we had together instead? Like when the two of us were backpacking in Denali National Park, Alaska, where we were nearly killed by hidden waterfalls and again the next day by grizzly bears. But both times we overcame!
> In the software realm, we've successfully created the Snaposit beta together in under a month, with each of us developing a major component.

We set up good lighting (two 500-watt halogen lamps into two silver umbrellas, one on each side of the camera, plus a large white disc reflector on the table in front of us for fill). We shot with a good camera (Canon 7D in 720i mode). We used a dedicated microphone (Zoom H4n's built-in mics, just out of frame above us).

We did take after take. We drank whiskey. We debated what to cover and what to leave out.

Finally, after a couple hours of takes, we did the final one: the one that would become the submitted video. Although parts of the video might seem a bit scripted, it was all improvised. Honestly, we probably would have done more takes had the camera's battery not died about 10 seconds after the final take concluded.

Was the video kind of cheesy? Yes. Were dark shirts a bad idea? Sure. Did it work? Apparently.

The video (posted on Posterous) was our only real tool to gauge interest in our application after submission. We watched the view counter slowly tick up as the days went buy. As the views went up, so did our excitement.

Our dream came true; Tyler relayed the good news to me. We booked flights to San Francisco, celebrated, and buckled down to really refine our demo for the YC partners.

The morning of the interview found us in the upper floor of Red Rock Coffee Shop in Mountain View. We were banging away on the code, trying to deal with some major performance bugs that had emerged when we switched to a local demo web server.

> *If you've already started working on it, how long have you been working and how many lines of code (if applicable) have you written?*
> We have been working on the code for about a month. Currently, we have about 3,000 lines of Python in the cross-platform client and another 2,500 lines of Python, HTML, Javascript, and CSS in the website.

About half an hour before our scheduled interview time, we made the short drive from downtown Mountain View to the Y Combinator offices.

I'd never before been somewhere so orange. Hundreds of young guys — they were almost exclusively male, and most seemed to be in their 20s — milled about the large common area. Laptops bloomed from tables like daffodils in the spring.

We checked in and went through our demo a few more times. Several other people tried to chat us up, but we politely declined. We were focused on the interview, and everything else before then would just be noise.

Finally, the time came. And went. And we still were outside of the interview room.

Paul Graham came out and made himself a smoothie. He needed a short break, he said. He was barefoot.

> *Please tell us something surprising or amusing that one of you has discovered. (The answer need not be related to your project.)*
>
> * USGS topographical maps in Alaska are not detailed enough to show hidden waterfalls. Discovering this fact was nearly catastrophic for us.
> * The best cinnamon roll yet discovered is about 75 miles north of Fort Nelson, BC
> * eBay generates almost 27% more revenue on Sundays than on any other day.

Since research has shown that judges are more lenient on full stomachs, Tyler and I thought it was great that Paul was eating something.

The interview began. Paul, along with Trevor Blackwell and Robert Morris, grilled us on our business model over and over. They seemed to accept our problem as genuine, but they seemed unconvinced that our solution was the right one. Minutes went by. I felt that I wasn't paying enough attention to Robert, but I couldn't seem to fix it.

More time went by. They kept wanting to compare Snaposit to Dropbox, and we kept trying to tell them that we were solving a different problem. Finally, the 10-minute timer beeped zero — and we hadn't even shown them our demo.

We raced through the demo of our prototype, and the three YC partners seemed unimpressed.

We were ushered out of the room, and I knew that we had failed to make a good impression. We should have been better prepared to defend our solution. At the same time, we shouldn't have appeared so set on our existing solution and expressed more willingness to adapt (should it prove necessary).

Our heads were swimming as we left the YC building. We decided liquor was in order.

We spent a couple hours at a bar in downtown Mountain View and then met some friends from undergrad at a nearby restaurant. All the while, we were waiting anxiously for a phone call from YC. It never came.

Halfway through dinner, we got the rejection email.

Start of the YC rejection email

Tyler and I resolved to continue working on Snaposit, and so we did. The private beta led to the public beta, which gave way to the general launch. However, the YC partners' concerns proved prescient: we had identified the right problem but the wrong solution. Not enough people wanted Snaposit.

After evaluating the opportunities for pivoting and surveying our non-customers to find out what would make them happy, we decided that there were no realistic paths to salvaging Snaposit. We tried, we failed, and we were going to move on. Snaposit will be dead by the end of the year.

In the meantime, my other photography software tool has taken off. Blurity, a tool for unblurring blurry photos, is doing great.

Tyler is also doing well, with no shortage of projects to keep him busy.

Snaposit didn't work out, but we had a great experience building it. Interviewing with YC was fantastic, and the partners were even sharper than we gave them credit for. Was it all worth it? Without hesitation: yes.

(For an alternative treatment of this story, see Tyler's write-up from May and his later discussion about why Snaposit failed)

Comments are closed.

How Much Traction Does a Startup Need to Raise Angel Money | 10,000 Startup Hours - David Cummings
davidcummings.org

500 Startups has a great checklist for investing in startups that includes items like capital-efficient, internet-based distribution, simple revenue model, functional prototype, small but measurable usage, and more. One area that's vague but super important is around the small but measurable product usage or early revenue, otherwise known as traction.

In most of the country, startups need to have some level of traction to raise money unless it's an entrepreneur that's been successful before. Here are some thoughts on the amount of traction needed to raise angel money:

- Valuations of $1 million – $1.5 million pre-money are pretty standard when startups have $25,000 – $100,000 in annual recurring revenue
- Valuations start to move up once the startup has $250,000+ in recurring revenue
- After $1MM in recurring revenue is achieved, valuations move up significantly (e.g. $5MM – $8MM pre-money) as the venture is often getting close to a repeatable customer acquisition process and the business is viewed as less risky

Most startups I meet with are pre-revenue and in a difficult spot because angel investors want to see some traction, even if it's modest, before investing. Entrepreneurs would do well to have a fair amount of recurring revenue to raise money on good terms.

What else? What are your thoughts on the amount of traction a startup needs to raise angel money?

The Value of Fundraising - VentureBlog
ventureblog.com

In 2012 my partners and I raised our sixth fund, aptly named August VI. August VI is a $550 Million fund, with $300 Million focused on early stage opportunities and $250 Million designated for what we call "Special Opportunities" (spinouts, take private transactions, later stage opportunities, etc.). As we have done since 1995, we will continue to pursue companies in the information technology space broadly (software, hardware, communications, Web, etc.). The fundraising behind us, we can now focus on finding great new companies in which to invest. But as we start the new year, I want to take a minute to reflect on the fundraising process.VCs don't like to talk about our own fundraising. We like to pretend that the money magically appears in our bank accounts. But that's not quite true. Venture Capitalists are investors, and the vast majority of the money we invest is not our own. Where does the money come from? We go out and raise it — from foundations and endowments and fund of funds (who raise it from other investors).Our fundraising process is not so different from that of the entrepreneurs who pitch us. We approach investors who can write big checks and we convince them that tens of millions of dollars invested today might turn into hundreds of millions of dollars tomorrow. We convince them to invest in our funds despite the long odds. We convince them to invest in our funds despite the innumerable alternatives they have. We convince them to invest in us despite the countless other investors who are promising outsized returns on a daily basis. And if we are successful in convincing these financiers to invest in our funds, we'll spend the next decade or more working hard to produce great returns.I have always felt that the fundraising process is an important part of company building — not just as a necessary evil, but as an intrinsically valuable exercise. Having just raised my own "round of funding," I am more convinced than ever. The fundraising process acts as a catalyst in a number of valuable ways that are worth exploring:

- The fundraising process forces you to better define and defend your business strategy. While an executive summary may allow you to speak in generalities, face to face fundraising requires specificity. A defensible strategy is not something you can fake. Potential investors will dig into your assumptions in ways that you may or may not have considered. No matter what the outcome, the conversation is a valuable one.
- The fundraising process allows you to hone your strategy and your pitch. Great entrepreneurs (when they have the luxury of doing so) will often pitch second tier investors first, in order to practice their delivery. The pitch will get better with time and practice, as will the strategy. And it isn't just rhetoric. You'll learn a great deal about your business defending it to a bunch of smart people.
- The fundraising process will disabuse you of your misconceptions. Entrepreneurs and VCs are invariably optimists. And, thus, they are prone to drinking their own kool-aid. Potential investors do not share your malady. They will work hard to determine if your kool-aid is in fact delicious, and if it is not, they will let you know. Now not everyone's taste buds are the same. Your kool-aid may not be delicious to everyone. But if it is delicious to no one, it is time to reassess.
- The fundraising process will provide you with valuable market intelligence. Think what you may of investors (whether they are VCs or the folks investing in VCs), they hear a lot of pitches. And all of those pitches can provide beneficial context for your own fundraising process (as well as your business in general). It is an investors job to compare your business with all other opportunities that come before them and to determine the relative value of what you are selling. If an investor has seen something better, it is invaluable for you to hear what it is and why (even if you ultimately think they're wrong).
- The fundraising process will help you determine if you have the right team. For venture capitalists this is extremely important because, in many ways, a VC fund is nothing more than the aggregation of that fund's partners. But the same holds true for startups. Investors, by and large, are betting on teams, not ideas or markets. If you don't have a credible team, potential investors will let you know.

I am grateful to have had the opportunity to pitch August Capital to some of the best Limited Partners in the country. I am certain that their feedback has made us better, more thoughtful, investors. And, in turn, we should be able to deliver even better returns for them. The same is assuredly true of every company out pitching today. Don't think of fundraising as a burden. Think of it as an opportunity. And, in return, you will get far more out of the process than just money.

A Quick Hack for Speeding up Term Sheet and other Negotiations
bothsidesofthetable.com

I've started a series on negotiations in startups. In it I list some books and also link to some of my previous posts. It's the first functional series I've done since sales & marketing.

The very first time I ever negotiated a term sheet (and then legal docs for closing the round) I found the experience very frustrating. I was desperate to get my funding finalized to derisk my business as well as to get capital in the bank to meet our growing cash needs.

But my VC didn't seem to be in such a rush. Nor did their lawyer.

The process went something like this:

- My lawyer tells me 8 clauses that need to change. He marks up the term sheet. We take a half a day to agree the points and send them over. Seems like the term sheet will be done in a day or so.

- The other law firm gets the docs. They're traveling that day. They are in a board meeting with clients. We press them 24 hours later. They say, "I haven't been able to reach my client (the VC) yet." We hear back in 2 days
- We get back our version. They've totally ignored 5 of our requests and marked up the other 3. Four days have now passed.
- I call the VC to discuss. He says, "I'm not sure your lawyer knows what he's doing. These are strange requests."
- I talk to my lawyer. He says the other lawyer must never have worked on a startup deal before. We agree where we can live without our points being met. He concedes on one point and sends over our doc re-marked up.
- Rinse. Repeat. 10 days have passed. Four points are open. We finally get focus on those points. We whittle it down to two. I find out my lawyer was digging in on something I thought was important but the more I understood the issue it seemed like an edge case.
- I talk to the VC. We work the two issues. We compromise. We move on. We ask the lawyers to mock up the docs. We sign. 13 days have passed.

Whew. Now the hard part begins. Now we move to definitive documents (long-form legal docs) and the whole freakin process starts again. This is not atypical and I found it very frustrating.

I talked to my co-founder Brian Moran (we launched the company in Ireland) about it. He had been working in the 1990's for a large global real estate developer called Hines (which he has now rejoined).

He told me that when they needed docs signed they had "signing parties" where they made every party involved with a project fly to a single location and they would all stay in a hotel together until the deal was completed. He said to me,

> *"We had a lot of money at stake. Delays in a project could cost us millions of dollars.*
>
> *It was a very small fee for us to pay for everybody to fly together and stay in a hotel relative to the costs of delays.*
>
> *Naturally when people are located in different places and working on different projects, documents don't get turned around fast enough and you're always waiting for somebody."*

So we thought, "Why not have a 'signing party' for our company?

We asked the VC, their lawyer and our lawyer to join us for a working session where we could walk through our legal docs page-by-page until they were completed.

I was surprised how reluctant everybody was. I realized that their lawyer much preferred not giving up his working hours. He would prefer to turn the docs at 1am between other stuff he was working on. And by "1am" I mean three days from now. And without agreeing all of our points.

My VC wasn't that keen either.

But they acquiesced. We spent several hours in a room. We took several breaks for each side to discuss issues privately that were in contention. We made phone calls to others. The VC mostly to come back and say some version of, "In all of the 50 deals we've seen in our portfolio we've never seen this term approved."

[side note: please don't fall for that line. either the point makes sense or it doesn't. I have seen VCs hide behind this "we've never done it before" line many times]

Anyway. It was a long day but at the end of the meeting we had a final agreement. The lawyers drafted it within 48 hours and we signed it in 72 hours. 1 week later the market crash of 2000 began and the dot com market began to collapse and financings with it.

It's not always easy to get the various parties of your deal to agree to be in a room all together at one time. But if you can make it happen I promise it's a much faster way to get a deal done.

And it obviously doesn't just apply to a VC financing.

Image courtesy of Fotolia

A VC: Continuous Feedback
avc.com

Continuous Feedback

We have a portfolio company that will remain nameless that does something I want to call out as super awesome. Every board meeting, as homework after the meeting, they ask each board member to fill out a simple Google Form with two questions; three things we are doing well and three things we need to do better. They've been doing that every board meeting that I've been to.

They use this information as part of their continuous feedback loop to improve their management of the business and in turn improve the business. Based on their progress since our investment, I'd say it works pretty well.

This is one example of a larger theme I am noticing in our portfolio and the startup world at large. Companies are using simple web tools to get continuous feedback on their performance. They are using this kind of approach to do performance reviews of everyone in the organization, they are using this kind of approach to get feedback from their customers, and they are using this kind of approach to get feedback from their Board, investors, and advisors.

This makes a ton of sense. Startups are rapidly changing systems. If you use an annual review cycle, you aren't getting feedback at the same pace that you need to adapt and change the business. Doing this kind of thing continuously matches the frequency of the feedback loop with the frequency of the business.

I've written in the past about continuous deployment and how I have seen that work really well at some of our portfolio companies. Continuous feedback leverages many of the same principals and has many of the same advantages. If you haven't tried this approach, you might want to. From what I've seen, it works.

November 15, 2011 –
Tweet

A VC: How Much Money To Raise
avc.com

How Much Money To Raise

Image via Wikipedia

I spent some time yesterday talking to an entrepreneur about this topic and I thought I'd share what I told him with everyone.

When your company is growing really fast, doubling employees year over year, adding users and customers at a very rapid rate, you don't want to raise too much money. If you raise three or four years of cash, there is a very good chance that by your second year, you will be sitting on cash that you raised when your company was worth considerably less. That's not a good thing. It's too dilutive to you and your co-founders and angels.

I've got two basic rules of thumb. First, try to dilute in the 10-20% band whenever you raise money. If you can keep it to 10%, that is great. You might have to do more, but try hard to keep your dilution below 20% each round. If you do two or three rounds at north of 20% each round, you'll end up with too little of the company.

Second, raise 12-18 months of cash each time you raise money. Less than a year is too little. You'll be raising money again before you know it. Longer than 18 months means you may well be sitting on cash that you raised when your company was worth a lot less.

These rules are most applicable in the early stages. When your company gets above 100 employees

and valued at north of $50mm, things change. You may need to have more cash on your balance sheet for working capital reasons and you may not be increasing value at quite the same rate as you were when you were smaller. You might want to raise 24 months of cash or more at that stage.

But for the seed, Series A, and Series B rounds, I think 10-20% dilution and 12-18 months of cash are ideal. It's what I advise our portfolio companies to do and it is what I advise other entrepreneurs to do.

July 3, 2011 –

Tweet

The Future of Startup Funding
Paul Graham

Want to start a startup? Get funded by Y Combinator.

August 2010

Two years ago I wrote about what I called "a huge, unexploited opportunity in startup funding:" the growing disconnect between VCs, whose current business model requires them to invest large amounts, and a large class of startups that need less than they used to. Increasingly, startups want a couple hundred thousand dollars, not a couple million. [1]

The opportunity is a lot less unexploited now. Investors have poured into this territory from both directions. VCs are much more likely to make angel-sized investments than they were a year ago. And meanwhile the past year has seen a dramatic increase in a new type of investor: the super-angel, who operates like an angel, but using other people's money, like a VC.

Though a lot of investors are entering this territory, there is still room for more. The distribution of investors should mirror the distribution of startups, which has the usual power law dropoff. So there should be a lot more people investing tens or hundreds of thousands than millions. [2]

In fact, it may be good for angels that there are more people doing angel-sized deals, because if angel rounds become more legitimate, then startups may start to opt for angel rounds even when they could, if they wanted, raise series A rounds from VCs. One reason startups prefer series A rounds is that they're more prestigious. But if angel investors become more active and better known, they'll increasingly be able to compete with VCs in brand.

Of course, prestige isn't the main reason to prefer a series A round. A startup will probably get more attention from investors in a series A round than an angel round. So if a startup is choosing between an angel round and an A round from a good VC fund, I usually advise them to take the A round. [3]

But while series A rounds aren't going away, I think VCs should be more worried about super-angels than vice versa. Despite their name, the super-angels are really mini VC funds, and they clearly have existing VCs in their sights.

They would seem to have history on their side. The pattern here seems the same one we see when startups and established companies enter a new market. Online video becomes possible, and YouTube plunges right in, while existing media companies embrace it only half-willingly, driven more by fear than hope, and aiming more to protect their turf than to do great things for users. Ditto for PayPal. This pattern is repeated over and over, and it's usually the invaders who win. In this case the super-angels are the invaders. Angel rounds are their whole business, as online video was for YouTube. Whereas VCs who make angel investments mostly do it as a way to generate deal flow for series A rounds. [4]

On the other hand, startup investing is a very strange business. Nearly all the returns are concentrated in a few big winners. If the super-angels merely fail to invest in (and to some extent produce) the big winners, they'll be out of business, even if they invest in all the others.

VCs

Why don't VCs start doing smaller series A rounds? The sticking point is board seats. In a traditional series A round, the partner whose deal it is takes a seat on the startup's board. If we assume the average

startup runs for 6 years and a partner can bear to be on 12 boards at once, then a VC fund can do 2 series A deals per partner per year.

It has always seemed to me the solution is to take fewer board seats. You don't have to be on the board to help a startup. Maybe VCs feel they need the power that comes with board membership to ensure their money isn't wasted. But have they tested that theory? Unless they've tried not taking board seats and found their returns are lower, they're not bracketing the problem.

I'm not saying VCs don't help startups. The good ones help them a lot. What I'm saying is that the kind of help that matters, you may not have to be a board member to give. [5]

How will this all play out? Some VCs will probably adapt, by doing more, smaller deals. I wouldn't be surprised if by streamlining their selection process and taking fewer board seats, VC funds could do 2 to 3 times as many series A rounds with no loss of quality.

But other VCs will make no more than superficial changes. VCs are conservative, and the threat to them isn't mortal. The VC funds that don't adapt won't be violently displaced. They'll edge gradually into a different business without realizing it. They'll still do what they will call series A rounds, but these will increasingly be de facto series B rounds. [6]

In such rounds they won't get the 25 to 40% of the company they do now. You don't give up as much of the company in later rounds unless something is seriously wrong. Since the VCs who don't adapt will be investing later, their returns from winners may be smaller. But investing later should also mean they have fewer losers. So their ratio of risk to return may be the same or even better. They'll just have become a different, more conservative, type of investment.

Angels

In the big angel rounds that increasingly compete with series A rounds, the investors won't take as much equity as VCs do now. And VCs who try to compete with angels by doing more, smaller deals will probably find they have to take less equity to do it. Which is good news for founders: they'll get to keep more of the company.

The deal terms of angel rounds will become less restrictive too—not just less restrictive than series A terms, but less restrictive than angel terms have traditionally been.

In the future, angel rounds will less often be for specific amounts or have a lead investor. In the old days, the standard m.o. for startups was to find one angel to act as the lead investor. You'd negotiate a round size and valuation with the lead, who'd supply some but not all of the money. Then the startup and the lead would cooperate to find the rest.

The future of angel rounds looks more like this: instead of a fixed round size, startups will do a rolling close, where they take money from investors one at a time till they feel they have enough. [7] And though there's going to be one investor who gives them the first check, and his or her help in recruiting other investors will certainly be welcome, this initial investor will no longer be the lead in the old sense of managing the round. The startup will now do that themselves.

There will continue to be lead investors in the sense of investors who take the lead in *advising* a startup. They may also make the biggest investment. But they won't always have to be the one terms are negotiated with, or be the first money in, as they have in the past. Standardized paperwork will do away with the need to negotiate anything except the valuation, and that will get easier too.

If multiple investors have to share a valuation, it will be whatever the startup can get from the first one to write a check, limited by their guess at whether this will make later investors balk. But there may not have to be just one valuation. Startups are increasingly raising money on convertible notes, and convertible notes have not valuations but at most valuation *caps*: caps on what the effective valuation will be when the debt converts to equity (in a later round, or upon acquisition if that happens first). That's an important difference because it means a startup could do multiple notes at once with different caps. This is now starting to happen, and I predict it will become more common.

Sheep

The reason things are moving this way is that the old way sucked for startups. Leads could (and did) use a fixed size round as a legitimate-seeming way of saying what all founders hate to hear: I'll invest if

other people will. Most investors, unable to judge startups for themselves, rely instead on the opinions of other investors. If everyone wants in, they want in too; if not, not. Founders hate this because it's a recipe for deadlock, and delay is the thing a startup can least afford. Most investors know this m.o. is lame, and few say openly that they're doing it. But the craftier ones achieve the same result by offering to lead rounds of fixed size and supplying only part of the money. If the startup can't raise the rest, the lead is out too. How could they go ahead with the deal? The startup would be underfunded!

In the future, investors will increasingly be unable to offer investment subject to contingencies like other people investing. Or rather, investors who do that will get last place in line. Startups will go to them only to fill up rounds that are mostly subscribed. And since hot startups tend to have rounds that are oversubscribed, being last in line means they'll probably miss the hot deals. Hot deals and successful startups are not identical, but there is a significant correlation. [8] So investors who won't invest unilaterally will have lower returns.

Investors will probably find they do better when deprived of this crutch anyway. Chasing hot deals doesn't make investors choose better; it just makes them feel better about their choices. I've seen feeding frenzies both form and fall apart many times, and as far as I can tell they're mostly random. [9] If investors can no longer rely on their herd instincts, they'll have to think more about each startup before investing. They may be surprised how well this works.

Deadlock wasn't the only disadvantage of letting a lead investor manage an angel round. The investors would not infrequently collude to push down the valuation. And rounds took too long to close, because however motivated the lead was to get the round closed, he was not a tenth as motivated as the startup.

Increasingly, startups are taking charge of their own angel rounds. Only a few do so far, but I think we can already declare the old way dead, because those few are the best startups. They're the ones in a position to tell investors how the round is going to work. And if the startups you want to invest in do things a certain way, what difference does it make what the others do?

Traction

In fact, it may be slightly misleading to say that angel rounds will increasingly take the place of series A rounds. What's really happening is that startup-controlled rounds are taking the place of investor-controlled rounds.

This is an instance of a very important meta-trend, one that Y Combinator itself has been based on from the beginning: founders are becoming increasingly powerful relative to investors. So if you want to predict what the future of venture funding will be like, just ask: how would founders like it to be? One by one, all the things founders dislike about raising money are going to get eliminated. [10]

Using that heuristic, I'll predict a couple more things. One is that investors will increasingly be unable to wait for startups to have "traction" before they put in significant money. It's hard to predict in advance which startups will succeed. So most investors prefer, if they can, to wait till the startup is already succeeding, then jump in quickly with an offer. Startups hate this as well, partly because it tends to create deadlock, and partly because it seems kind of slimy. If you're a promising startup but don't yet have significant growth, all the investors are your friends in words, but few are in actions. They all say they love you, but they all wait to invest. Then when you start to see growth, they claim they were your friend all along, and are aghast at the thought you'd be so disloyal as to leave them out of your round. If founders become more powerful, they'll be able to make investors give them more money upfront.

(The worst variant of this behavior is the tranched deal, where the investor makes a small initial investment, with more to follow if the startup does well. In effect, this structure gives the investor a free option on the next round, which they'll only take if it's worse for the startup than they could get in the open market. Tranched deals are an abuse. They're increasingly rare, and they're going to get rarer.) [11]

Investors don't like trying to predict which startups will succeed, but increasingly they'll have to. Though the way that happens won't necessarily be that the behavior of existing investors will change; it may instead be that they'll be replaced by other investors with different behavior—that investors who

understand startups well enough to take on the hard problem of predicting their trajectory will tend to displace suits whose skills lie more in raising money from LPs.

Speed

The other thing founders hate most about fundraising is how long it takes. So as founders become more powerful, rounds should start to close faster.

Fundraising is still terribly distracting for startups. If you're a founder in the middle of raising a round, the round is the top idea in your mind, which means working on the company isn't. If a round takes 2 months to close, which is reasonably fast by present standards, that means 2 months during which the company is basically treading water. That's the worst thing a startup could do.

So if investors want to get the best deals, the way to do it will be to close faster. Investors don't need weeks to make up their minds anyway. We decide based on about 10 minutes of reading an application plus 10 minutes of in person interview, and we only regret about 10% of our decisions. If we can decide in 20 minutes, surely the next round of investors can decide in a couple days. [12]

There are a lot of institutionalized delays in startup funding: the multi-week mating dance with investors; the distinction between termsheets and deals; the fact that each series A has enormously elaborate, custom paperwork. Both founders and investors tend to take these for granted. It's the way things have always been. But ultimately the reason these delays exist is that they're to the advantage of investors. More time gives investors more information about a startup's trajectory, and it also tends to make startups more pliable in negotiations, since they're usually short of money.

These conventions weren't designed to drag out the funding process, but that's why they're allowed to persist. Slowness is to the advantage of investors, who have in the past been the ones with the most power. But there is no need for rounds to take months or even weeks to close, and once founders realize that, it's going to stop. Not just in angel rounds, but in series A rounds too. The future is simple deals with standard terms, done quickly.

One minor abuse that will get corrected in the process is option pools. In a traditional series A round, before the VCs invest they make the company set aside a block of stock for future hires—usually between 10 and 30% of the company. The point is to ensure this dilution is borne by the existing shareholders. The practice isn't dishonest; founders know what's going on. But it makes deals unnecessarily complicated. In effect the valuation is 2 numbers. There's no need to keep doing this. [13]

The final thing founders want is to be able to sell some of their own stock in later rounds. This won't be a change, because the practice is now quite common. A lot of investors hated the idea, but the world hasn't exploded as a result, so it will happen more, and more openly.

Surprise

I've talked here about a bunch of changes that will be forced on investors as founders become more powerful. Now the good news: investors may actually make more money as a result.

A couple days ago an interviewer asked me if founders having more power would be better or worse for the world. I was surprised, because I'd never considered that question. Better or worse, it's happening. But after a second's reflection, the answer seemed obvious. Founders understand their companies better than investors, and it has to be better if the people with more knowledge have more power.

One of the mistakes novice pilots make is overcontrolling the aircraft: applying corrections too vigorously, so the aircraft oscillates about the desired configuration instead of approaching it asymptotically. It seems probable that investors have till now on average been overcontrolling their portfolio companies. In a lot of startups, the biggest source of stress for the founders is not competitors but investors. Certainly it was for us at Viaweb. And this is not a new phenomenon: investors were James Watt's biggest problem too. If having less power prevents investors from overcontrolling startups, it should be better not just for founders but for investors too.

Investors may end up with less stock per startup, but startups will probably do better with founders more in control, and there will almost certainly be more of them. Investors all compete with one another for deals, but they aren't one another's main competitor. Our main competitor is employers. And so far

that competitor is crushing us. Only a tiny fraction of people who could start a startup do. Nearly all customers choose the competing product, a job. Why? Well, let's look at the product we're offering. An unbiased review would go something like this:

> Starting a startup gives you more freedom and the opportunity to make a lot more money than a job, but it's also hard work and at times very stressful.

Much of the stress comes from dealing with investors. If reforming the investment process removed that stress, we'd make our product much more attractive. The kind of people who make good startup founders don't mind dealing with technical problems—they enjoy technical problems—but they hate the type of problems investors cause.

Investors have no idea that when they maltreat one startup, they're preventing 10 others from happening, but they are. Indirectly, but they are. So when investors stop trying to squeeze a little more out of their existing deals, they'll find they're net ahead, because so many more new deals appear.

One of our axioms at Y Combinator is not to think of deal flow as a zero-sum game. Our main focus is to encourage more startups to happen, not to win a larger share of the existing stream. We've found this principle very useful, and we think as it spreads outward it will help later stage investors as well.

"Make something people want" applies to us too.

Notes

[1] In this essay I'm talking mainly about software startups. These points don't apply to types of startups that are still expensive to start, e.g. in energy or biotech.

Even the cheap kinds of startups will generally raise large amounts at some point, when they want to hire a lot of people. What has changed is how much they can get done before that.

[2] It's not the distribution of good startups that has a power law dropoff, but the distribution of potentially good startups, which is to say, good deals. There are lots of potential winners, from which a few actual winners emerge with hyperlinear certainty.

[3] As I was writing this, I asked some founders who'd taken series A rounds from top VC funds whether it was worth it, and they unanimously said yes.

The quality of investor is more important than the type of round, though. I'd take an angel round from good angels over a series A from a mediocre VC.

[4] Founders also worry that taking an angel investment from a VC means they'll look bad if the VC declines to participate in the next round. The trend of VC angel investing is so new that it's hard to say how justified this worry is.

Another danger, pointed out by Mitch Kapor, is that if VCs are only doing angel deals to generate series A deal flow, then their incentives aren't aligned with the founders'. The founders want the valuation of the next round to be high, and the VCs want it to be low. Again, hard to say yet how much of a problem this will be.

[5] Josh Kopelman pointed out that another way to be on fewer boards at once is to take board seats for shorter periods.

[6] Google was in this respect as so many others the pattern for the future. It would be great for VCs if the similarity extended to returns. That's probably too much to hope for, but the returns may be somewhat higher, as I explain later.

[7] Doing a rolling close doesn't mean the company is always raising money. That would be a distraction. The point of a rolling close is to make fundraising take less time, not more. With a classic fixed sized round, you don't get any money till all the investors agree, and that often creates a situation where they all sit waiting for the others to act. A rolling close usually prevents this.

[8] There are two (non-exclusive) causes of hot deals: the quality of the company, and domino effects among investors. The former is obviously a better predictor of success.

[9] Some of the randomness is concealed by the fact that investment is a self fulfilling prophecy.

[10] The shift in power to founders is exaggerated now because it's a seller's market. On the next downtick it will seem like I overstated the case. But on the next uptick after that, founders will seem

more powerful than ever.

[11] More generally, it will become less common for the same investor to invest in successive rounds, except when exercising an option to maintain their percentage. When the same investor invests in successive rounds, it often means the startup isn't getting market price. They may not care; they may prefer to work with an investor they already know; but as the investment market becomes more efficient, it will become increasingly easy to get market price if they want it. Which in turn means the investment community will tend to become more stratified.

[12] The two 10 minuteses have 3 weeks between them so founders can get cheap plane tickets, but except for that they could be adjacent.

[13] I'm not saying option pools themselves will go away. They're an administrative convenience. What will go away is investors requiring them.

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Want to Know How VC's Calculate Valuation Differently from Founders? | Both Sides of the Table
bothsidesofthetable.com

Back in 1999 when I first raised venture capital I had zero knowledge of what a fair term sheet looked like or how to value my company. Due to competitive markets we ended up with a pretty good term sheet until we needed to raise money in April 2001 and then we got completely screwed. It was accept the terms or go into bankruptcy so we took the money. Those were the dog days of

entrepreneurship.

But the truth is that I didn't really understand just how screwed I was until years later when I finally understood every term in a term sheet and more importantly I understood how each term could actually be used to screw me. Things like "participating preferred stock" in legalese unsurprisingly never actually call out, "hey, this is the participating preferred language." We got a 3x participating liquidation preference with interest (not participating with a 3x cap, but 3x participating. Ugh. I explain the difference later in the post or you can click through on this link above for an explanation).

Back then VentureHacks didn't exist. Brad Feld hadn't written his seminal "term sheet series" and The Funded hadn't yet been created. And for some strange reason entrepreneurs didn't share this information. Other founders, "as a privately held company we don't disclose our valuation." Me, "dude, I'm not a journalist. I just want to figure out what a fair valuation is." I figured all the VC's talked so we should. Duh.

I don't feel that as a VC sneaking in nefarious terms into a term sheet that the entrepreneur doesn't understand is a good way to build a long-term relationship nor to build a long-term reputation but this does happen and more frequently than we all would like. I've started from day one trying to build total transparency into my process with entrepreneurs.

This starts with understanding how VCs and entrepreneurs often see valuation differently. And no prizes for guessing which side of the table really understands the right answer. I'm not sure I really even need to write this at length because Nivi absolutely nailed the topic in his article "The Option Pool Shuffle."

When I went to raise money in 2006 I thought I knew every term in a term sheet but somehow I still got a bit duped by the option pool shuffle. I had several term sheets and one of the leading term sheets had an option pool of 40% in it. I couldn't understand why they wanted so many options until a friend pointed out that this just lowered their "true" pre-money valuation (they also asked for some sharp elbowed terms in the deal).

I turned them down. They were nonplussed. They couldn't understand how I could turn them down when they considered themselves the leader in my field and they had worked so hard to get the deal. I told them that True Ventures had stuck to their brand name and submitted a totally clean term sheet. No gotchas. No option pool shuffle. No hidden terms. So they agreed to match True's term sheet. I thought to myself, "OK, they were willing to F me when they thought I had no idea what I was talking about . Now that I do they're willing to accommodate? Gee, if they treat me like this in good times I wonder how they'd treat me in bad times!"

So to make sure it never happens to you, as a loyal reader of this blog and hopefully an occasional watcher of This Week in Venture Capital, I recorded a video session with my colleague Kelly Hwang on how VCs calculate valuations and he's created a cap table spreadsheet you can download from DocStoc to plug in all of the terms and you can watch the video here and/or read the text summary below.

How VC's Calculate Valuation: We walked through a standard deal where you raise $1 million at a $3 million pre-money valuation leading to a $4 million post money valuation. The math works out that the investor owns 25% of the company post deal ($1 million invested / $4 million valuation) and assuming 1 million shares, each share would be valued at $3 / share ($3,000,000 pre-money / 1 million shares = $3 / share). Investors own 25%, the founders own 75%. NOTE: In the video I talked about how VC's and entrepreneurs decide the total number of shares at the first major funding round and why it's often a high number.

But this example above is all entrepreneur math, not the VC's. The VC assumes you'll have an option pool. That's normal. You'll need to hire and retain talen to grow your company. Those options need to come from somewhere. The more senior members you have (say you already have a CEO, CTO, VP marketing, VP Biz Dev, VP Products) then the less options you'll need and vice versa. Industry standard post your first round of funding will be 15-20%. I say "post" funding because you'll need more than this amount pre-funding to get to this number after funding. We walk through this in

the video.

So taking the same fund raising round and assuming that the VC wants the options including **before** he or she funds (and before is totally standard) then the math works like this: Assuming a 15% option pool post funding then you need a 20% option pool pre funding (because the pool gets diluted by 25% also when the VC invests their money). So your 100% of the company is down to 80% even before VC funding. Normal.

The VC's $1 million still buys them 25% of your company – it's you who has diluted to 60% ownership rather than 75%. The price / share is actually $2.40 (not $3.00), which is $3,000,000 pre-money / 1,250,000 shares (because you had to create the 250,000 share options). Thus the "true" pre-money is only $2.4 million (and not $3 million) because $2.40 per share * 1 million pre-money outstanding shards = $2.4 million.

Note that the term sheet you get will still say, "Pre-Money = $3 million" and there won't be anywhere in the term sheet that says "true Pre-Money" or "effective Pre-Money" – that's for you to calculate. So let's start calling the term sheet listed pre-money valuation as the "nominal" pre-money valuation. Luckily you all now have the spreadsheet to download that will calculate both for you.

Term Sheet Overview:

The second most important economic term in the term sheet other than price is ***"liquidation preference."*** This states how the proceeds from a sale or dissolution of the company will be distributed. Investors will always want to get their money out of the company before founders, which in the case where the company is sold for a low price is fair. You almost certainly will have liquidation preferences if you raise VC so don't worry about having them.

But not all liquidation preferences are equal – we discuss all this in the video – some can have a "multiple" on top of them such as a 2x liquidation preference, which means that investors get 2x their money before founders get anything. In an early round of investment where there is not an extremely high price relative to normal valuations this is anything but benign.

More likely what you'll see if you have an aggressive term sheet is "participating preferred" stock. This means that investors get their money back AND they get to share in the proceeds. If you've raised $6 million in total and still own 40% of the company and sell for $10 million (not a great outcome but it happens) then with participating preferred investors would take $6 million off the top and then 60% of the remaining $4 million so the founder's take would be $1.6 million (.4 * $4 million) and not $4 million. Note that it might be even less than $1.6m because liquidation preferences often have interest calculated on top of them.

VC's in early rounds will argue that "participation" is simply downside protection and if you sell for a lower price they should get more of the proceeds. While true, the problem I have is that any terms you have in your early stages will certainly be asked for by future investors in your later funding rounds so all of these terms pile up when you've been through 3-4 rounds of funding over a 5 year time frame. And by the time most companies get to an exit (which despite what you read on TechCrunch about all the high-profile early exits the most realistic case is still 8-10 years) often the founders own very little of the economic upside. This is a shame.

Privately some early-stage VC's talk about participation helping them to "juice their returns" on smaller exits. This is silly talk. I don't imagine any VC seriously makes money by having tons of small to mid-sized outcomes and therefore "juicing" to me is delusional. I think VCs make money by investing in 20-25 deals and finding 2-3 outliers that drive extra-ordinary returns. And those are often done by the best and smartest founders who have enough knowledge to know which VCs are juicers and which aren't. You reap what you sow.

I also won't say there is never a time for "participating preferred" but it tends to be in later-stage rounds and particularly in the case where the founders are getting an exceedingly high valuation relative to the norm. In those cases there are all sorts of mathematical reasons why participation might make sense. These are edge cases.

But for founders stuck in this negotiation about participation or not with VCs the most standard

compromise is "participation with a cap" which is usually set at 2-3x their investment. This means that participation truly only applies in downside scenarios and once your exit outcome is above a certain price investors would still be better off converting to common stock and not taking their preference. I prefer to see no participation but this is a good compromise if you can't get a straight 1x liquidation preference.

After valuation in the video we went through Liquidation Preferences, Board Seats, Protective Provision, Voting Rights, Drag Along Rights, Redemption, Anti-Dilution and a few other key terms. We spend a lot of time on them in the video but frankly we could have done a 3-hour session. If I get demand from people after this video to do a deeper dive on term sheets we will. Heck, maybe we'll even invite a lawyer on to do it with us!

Startups and VCs Should Avoid "Pier" Funding | Both Sides of the Table
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Often when startups who have raised venture capital need another round of financing they will turn to their existing investors to give them money before raising from outsiders.
This happens when the company has been making steady progress but hasn't built enough "proof" to raise its next round of financing from external investors.

The traditional way that this type of financing is offered is what is known as "convertible debt." This means that the investment does not have a valuation placed on it. It starts as a debt instrument (e.g. a loan) that is later converted to equity at the time of the next financing. If no financing happened then this "note" may not be converted and thus would be senior to the equity of the company in the case of a bankruptcy or asset sale.

If a round of funding does happen then this debt is converted into equity at the price that a new external investor pays with a "bonus" to the inside investor for having taken the risk of the loan. This bonus is often in the form of either a discount (e.g. the loan converts at 15-20% discout to the new money coming in) or your investor will get "warrant coverage" which is similar to an employee stock option in that it gives the investor the right but not the obligation to invest in your company in the future at a defined priced.

There is a primary reason that inside investors give companies convertible debt rather than just giving you the money as equity. VC's money comes from mostly institutional investors called LPs (limited partners). They trust the judgment of the VCs to source, finance, help manage and then create some sort of exit for the investments that they make. They also trust VC's to determine the right price to pay for the company securities that they buy.

But when a VC is already an investor in a company and when they can't raise external money it would set off a potential "red flag" with LPs. "Why weren't they able to raise external capital?" Or more importantly, "How do I know you're paying the right price to invest in the company? Maybe the market views this as not worth the price you paid? Or maybe you're biased and just investing because you've 'fallen in love' with the company and lost your objectivity." Whatever the case, VC's usually don't want to be seen to be driving price on a deal in which they've already invested.

So by offering convertible debt you can avoid a price discussion in the same way that angel investors sometimes do in order to win competitive early-stage deals. The industry jargon for convertible debt is a "bridge loan" or "bridge financing." It's called a bridge loan because it's meant to provide enough capital to bridge you from your last round of funding until your next round of funding. Basically it is supposed to give you enough runway to prove some milestones and make it easier for your to raise money from an outside source.

But I used to jokingly refer to bridge loans as "pier" loans. You know, because they give you a bit of runway but somehow it never seems like enough money to get you to the other side of the river. I understand the mentality of why investors do this. They want to give you enough money so that they

don't have a bankruptcy on their hands but not so much that if you eventually struggle to raise money they have lost even more money. Basically they get the chance to see how you perform "on a short leash" and if they feel you're doing well they can just keep extending the length of the pier 1-2 months at a time.

For me Pier Loans fall under the category of "penny wise, pound foolish." What VCs who have never been entrepreneurs and have therefore never been on the receiving end of small bridge loans don't realize is that they skew the behavior of startup management teams in ways that can be self destructive. You can only really know this for sure if you've been in these shoes. You get the bridge in place so you breathe a sigh of relief that you're going to live to fight another day but suddenly you because overly cautious. You don't want to be staring at a payroll that you don't know if you'll make again. You don't want to have a perpetual tin cup in your hands begging for scraps to exist.

So startup CEO's in this position make compromises that don't necessarily benefit the long-term potential of the company. They might not replace an engineer or two that quits. They might put the kibosh on company travel and not attend some key meetings or conferences. They might decide to delay new product features or upgrading technology infrastructure. They likely are extending payments to debtors way beyond that expected payment terms and start damaging supplier relations. And equally damning is that the culture inside the company drifts insidiously from confidence to cautiousness. From pragmatic risk taking to risk aversion. And startup CEO's can often suppress the anxiety that goes along with the funding uncertainty – even to themselves. But no doubt their bodies feel the stress. And it adds up.

So my view is that VCs and entrepreneurs need to make tougher choices. The sh** or get off the proverbial pot judgment calls and the answer isn't always "let's fund." I had a friend recently call me who had been offered a pier from his VC. He had raised about $500,000 in seed funding that lasted a long time. He got a good degree of user adoption but clearly hadn't proven his model. He talked to his investors about a $250,000 bridge loan (7-8 months of runway). Initially they acquiesced but when it came time to funding they only offered him $100,000. This is literally what I said to him (almost verbatim)

> *"Honestly, [name], I wouldn't take the money. You've been busting your arse on this opportunity for the past 18 months. You've kept a really low burn rate and paid yourself a very small salary. That's the risk you've accepted and the commitment you've made. I've seen the progress you've made but you clearly haven't knocked it out of the ball park. If you think you can still get a good return for your investor you should respectfully request that the minimum amount you'll take is $250,000.*
>
> *Tell them that if they're not confident enough to put the whole amount in you'd understand. The business hasn't been an unmitigated success. But if they do put in the money you'll work your butt off to do everything you can to make this company a winner. If they don't have the confidence that you can pull this off then you'd be happy to help either shut the company down in an orderly fashion, sell the assets to somebody on the cheap or help transition the company to somebody else to run it.*
>
> *I told him that if they're going to drip feed you (at $100k he'd have less than 3 months of cash) it wasn't worth staying. His scarcest resource was his youth and the energy he had to put into startup ventures when he has no kids, no mortgage and no major encumbrances. He had already given things his best effort."*

Frankly, if investors weren't willing to write the $250,000 check that they had promised it seemed clear to me that he had lost their support or that they weren't convinced in the future. These aren't angel investors or family friends for whom $250k might be a big deal. These are institutional VCs. I couldn't see any reason for him to continue to kill himself in that context.

So there you have it. Sh** or get off the pot. Have the conviction to back your companies enough to really give them a chance to prove themselves. I'm not talking about endless amounts of money but at least funding 6 months gives them 3 months to show progress and 3 months to fund raise. Better even

still if there's a way to fund 9 months. It's legitimate to ask for cost cutting if you think the bridge won't last long enough at the current burn rate.

But if you're tempted to offer a pier (or if you're tempted as a startup to take it) I think you're better off looking in the mirror and asking yourself the tough questions about why you lack the conviction. You might have legitimate concerns that warrant not funding the ongoing operations. But piers are often counter productive.

How To Communicate with your Investors between Board Meetings | Both Sides of the Table
bothsidesofthetable.com

Running the "Agile" Board

Most early stage startups having monthly board meetings. I normally recommend 8 meetings per year. It makes no sense to meet in August or December due to travel schedules of most investors. You can do calls if need be. And I often recommend that board meetings be every 5 or 6 weeks rather than 4 to give enough elapsed time for stuff to actually happen between meetings. Quarterly is too few for an early stage business.

But that isn't what this post is about. This post is about what happens BETWEEN board meetings. And most companies don't do enough between board meetings. Doing nothing between board meetings to me is like running the "waterfall software development process." We all know that modern software companies run on the "agile" development process by having short release cycles and frequent communications. Boards will thrive on this, too.

For the record, this is not a secret, coded messages to companies for which I am on the board! A prominent startup CEO in NYC wrote me a private message telling me that this was an issue he was struggling with. He has high-profile board members and was wondering what do communicate to them between meetings. This is written for him and for anybody else grappling with the same question.

First, let's look at the "normal" board meeting. I ran board meetings as a startup CEO for more than 8 years. I didn't love most of them. I found that too often it was an update meeting for investors rather than a meeting for my company to get value. I've written before about how to turn this equation around and run more effective board meetings. If you want to prevent board meetings simply becoming investor update meetings? If so, you need to do a better job of communicating between meetings so that they always feel well informed.

For starters, don't assume that everything I say here is what your investors want between meetings. I suspect many of them do but the best rule for any communications is to agree expectations. Make sure to ask them what they want.

VC's Want to Help!

To understand what most VC's want between board meetings I think it's useful to start with a quote from Mark Solon's blog for which I'm in complete agreement (along with agreeing with his entire post, which was brave, honest and accurate)

> *"The overwhelming majority of VCs I've worked with get up in the morning and think about how they're going to help their portfolio companies that day."*

That's it. Most VC's want to help. Most don't immediately know how. They mostly understand your company, your customers, your competitors and your market but never as precisely as you do. So help your VC's help you. Here's how:

Intros

So taking Mark Solon's comments into context, this is what most VCs want to help with most of the time. VCs know lots of people. They network with other VC's, other startups CEOs, larger industry players, journalists, potential executives looking for their next jobs, service providers such as venture

debt providers, etc.

And let's be honest, other than money and coaching most VC's add little value to your company strategy. I'm not trying to demean VC's – I think it's just reality. And deep down they know this. Yet they WANT to help. So the best way they can do this is by introducing you to people who can help you succeed.

But often they don't know the right people and therefore you often get a string of introductions of which some are awesome and some are unfocused. The unfocused ones add obligations to you. They don't do this on purpose. The best way to get the Glengarry leads is to tell them whom you want to meet. Here's what I recommend:

- Create a Google spreadsheet listing your top customer prospects, biz dev prospects and other companies you would like to meet.
- Have a column for "want to meet now, in 3 months, in 6 months, etc.". Listing the future "meets" will help them understand your future roadmap / thinking but will help avoid getting dropped into an exec meeting from which you're not ready
- Have a column for board members / investors to put their names against whom they know. This will help because no investor wants to be the one without their name against anybody. VC's compete amongst each other to show that they aren't the ones not adding value (a nice double negative, but true! ;-))
- Have a space where you say, "please add other useful intros you feel you could make" and encourage them to add more names
- Make sure to politely remind investors to run intro's by you before sending them out. We want to help. We don't want to be unfocused. But most VC's are "intro machines." Help them to be well behaved. Help them to follow your process. If you're polite and persistent they will – and they'll appreciate it.
- Make sure to send a monthly email to all board members / investors with a link to your spreadsheet saying, "I've made a few updates. I'd be grateful if you would quickly check the spreadsheet to see how you could help." We will not check proactively without a reminder. We're busy. We want to help. But we barely get through all our email let alone log into online spreadsheets.
- Make the spreadsheet short and focused. The longer it is the less likely we'll read and help. Feel free to have color coding for each member with companies for which you think they might be able to help with intros.
- Finally, make sure you print out the spreadsheet and quickly walk through it toward the end of your board meeting (it's not part of the strategic discussion – don't lead with it). This is partly to help you get the intro's you need while you're all in the room. It's party to remind board members that you walk through it each board meeting and they'll know if their name is never on it. It will help you to get them to remember to update it between meetings.
- Publicly thank any board member in your board meeting for an intro that led to something spectacular. I hate to sound dumb, but VC's are just like any other people and human behavior is predictable. They work hard to help you succeed. And the reality is that they'll never say they want recognition but it's nice to be recognized when you went out of your way and it paid off for somebody. That small recognition will help you get a bit more out of your VC's relative to other boards they sit on. I know any VC reading this will be wincing and thinking it isn't true. It is. We're all just grown up big kids who operate the same way we did when we were young. Recognition is Pavlovian.

Talking about you appropriately in the right settings

The other thing that VC's need between board meetings is a reminder of all of the key particulars on your company. They mostly get what you do and whom you compete with but they can't keep up with the constant changes. Make sure you have a simple elevator paragraph of what you do. It's not a mission statement. It's a 3 paragraph statement of what you do. It's the kind of thing you'd give to

your PR company if you could afford one.

Having these paragraphs in the hands of your investors will help ensure that they position you correctly when they talk to all the important people they see. If you've ever heard a VC introduce you to somebody and describe what you do, you'll know why you need this.

I also think it's a good idea to have a competitor matrix that shows your key competitors and how you feel you stack against them +/-. Unlike the intro Google spreadsheet for introductions, this isn't something they'll edit so don't make them log in to get it. I would send this out quarterly. Have a column against each competitor for "recent news" where you have a one paragraph update on your competitors movements.

- Knowing who the competitors are will help the VC with positioning you. It will help in your board meetings because you shouldn't spend tons of time talking about this in the board meeting. You can talk about "what to do about competitor moves" rather than reminding them who your competitors are.
- Don't send with board pack. Sending with all the other board materials will ensure that it is read in 30 seconds and not properly digested.

Positioning your progress correctly with their partners

The other big thing investors want to do is know how to talk about you with their partners. Most partnerships are exactly that – partnerships. We need to be sure we're not surprising our partners with negative news and want to share the positive stuff also. Make sure your investors are crystal clear about the things that their partners are going to ask them.

- Partners will ask about "recent high profile news" that might affect the company. If Apple announces their OS4 and it affects data gathered from the iPhone and you're using that data – assume their partners will ask how it affect you. Or if you're a mobile ad network and they announce iAd – same thing. Whenever a big announcement affects you I recommend you send your board / investors a quick email saying, "here's the iAd announcement and how we currently think it affects us." Be honest about what you know / don't know. They will be asked by their partners. They will appreciate your proactively telling them. They will likely forward your email to their partners. Make sure when you write it you assume this. Obviously you'll write "please keep this confidential" but don't assume it won't accidentally leak just a little bit. Be prudent.
- Make sure all board members / investors are clear when you think you'll run out of cash. This is the single biggest thing they shouldn't be surprised about. Even it it's 15 months away they need to know when you think you run out and when you think you'll need to be fund raising. Constantly remind them of these dates. They need to plan and they won't want to surprise their partners.

Showing up at board meetings ready to contribute

If you want your board members to show up at the board meeting ready to contribute then you need to send out board materials 72 hours in advance. Your board will say 1 day is fine and 2 days are plenty. They're not. People get busy. Most of them will read your board pack 30 minutes before the board meeting. So they have no time to think about it, read your numbers closely, have a quick phone call or two with you about things and generally prepare.

If you can get it done the day before why can't you get it done 3 days before? Send it early and make sure to continually remind people politely that you expect it to be read entirely before the meeting. If you want to be super prepped – call each board member for a 10 minute chat 1 day before the board meeting to chat about anything they saw in the board pack.

I know it sounds like overkill. But if you're not regularly talking with your board members anyways that's probably a problem. And having this pre board meeting really quick chat will make the board meeting more effective.

Update Notes – Your Board "Sprint" Process

I think the best way to keep your board members generally updated is to have a 1-page, bullet point

set of notes that you distribute via email every 2 weeks. It should be inline in the email rather than a document attachment. It should be MUCH shorter than this post so your board will actually read it rather than skim it.

- I recommend bullet points because it breaks up long text and makes it visually easier to read
- I would break up your section into three categories: major achievements in the past 2 weeks, plans for next 2 weeks, things we could use help with
- Make it clear to board members that it isn't an obligation that they consume every one of these but that you want to produce so people will feel a lightweight sense of what your company has been up to
- I know it will seem like overkill. If you keep it high-level enough it's not. It will help you better with planning, it will force you to make some commitments and it will help your board feel informed.
- Think of it this way: if having your development team work this way through sprints, why not board notes? ***Meeting every 6-8 weeks with no interim communication is like the waterfall software development process!***

And Finally – work the phones!

A lot of CEO's ask me for standing "update" phone calls. Most CEO's know that I hate the formality of these. If a board member is on 6 boards imagine how much admin it gives him/ her to have weekly update calls. But I DO love to speak to the CEO's all the time. Often, but impromptu. Get in the habit of calling board members frequents for quick updates or to ask for quick advice.

Resist the temptation to talk for a long time. If you get in the habit of calling and getting off within 10 minutes then your call will always be welcome. Not everybody works this way. And some people are fine with standing meetings and following a process. Me, not so much. So make sure to ask your board members what they want. I suspect many would say, "we don't need to speak on the phone all the time." But trust me, it's like vitamins – it's good for them. And you. So make it happen.

That way board meetings will be there to talk about what REALLY matters since you've gotten all of the routine kibitzing out of the way.

UPDATE: Having had great feedback on the topic from Babak Nivi and Brad Feld I wrote a short update to The Agile Board.