Better Ways to Finance Early-Stage Companies

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Introduction

- Today, conversations among entrepreneurs and angel investors often include:
- dangers of early-stage investors being washed out by subsequent rounds of financing.
- excruciatingly complex venture capital term sheets.
- boards dominated by individuals without adequate knowledge or with fundamental conflicts.

The Solution:

- <u>Fairness</u>
- <u>Alignment</u>
- <u>Governance</u>
- All built into the structure of the company,
- through the first investment agreement.

Early-Stage Investing Is Different

- The total capital invested might only be a few hundred thousand dollars.
- The legal fees should only be a few thousand dollars.
- This necessitates clean, simple documentation that is much shorter than standard VC investment agreements.
- KISS and focus on what’s really important for success.

Structures Still Being Developed

- When Angels invest, company structures and boards are often not well developed.
- Successful investors see this as more of an opportunity than a problem.
- At these stages in a company's development, it is easy to improve the structure and board.
- This can significantly improve the probability of a successful investment.
- Structures are like foundations in buildings.

Fairness

- Successful early-stage investing is always win-win.
- If the agreement is not actually fair, and seen to be fair,
- today, and in the future,
- the lack of fairness itself can be sufficient to cause an embryonic company to die.

Alignment

- The biggest problems with the typical VC preferred shares investment model are:
  - The dis-alignment created between the investors and the entrepreneurs, and
  - The fundamental conflicts created when VCs join the board.
- This builds failure modes into the corporate structure that may not be apparent for years.
- Angels and entrepreneurs are holding onto common share structures to maintain alignment.

Governance Instead of Legals

- VC investment agreements grew to 100+ pages because the investors did not trust the board to make the right decisions.
- This is the root cause of the dis-alignment.
- The solution is obvious:
  - Make a good board a pre-requisite to investing, and
  - built into the corporate structure.

Boards

- Boards are more important than CEOs.
- Even very young companies need engaged, capable boards.
- All directors, except the CEO, must be fully independent of management.
- All directors must have made a meaningful (to them) investment in the company.
- All nominees must be acceptable to the CEO and investors.

Being Fair to Directors

- There are usually two components to the director financial agreement at angel stages:
  1. Directors make a meaningful investment
  2. Directors earn a fair amount of sweat equity
- Essential ingredients for an engaged board
- At the Angel stage, the board should have about 10% of the total equity
- Vesting on the same terms as the entrepreneurs

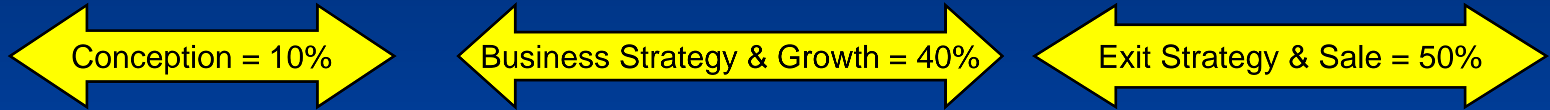
Vesting

- After the board, and equity allocation, is the most important element in successful structuring.
- Vesting is responsible for many more failures than is commonly appreciated,
- but is impossible to isolate from other personal and group factors.
- Is fundamental to fairness, alignment and motivation.
- The most fair vesting arrangement matches the intention of the entrepreneurs and investors.

The Fundamental Agreement

- Today, many are coming to believe that the fundamental agreement between investors and entrepreneurs is:
  1. The investors invest their money as equity
  2. The entrepreneurs all work together to increase the value of the equity, <u>and</u>
  3. Provide the investors, and themselves, liquidity.

Shareholder Value Creation



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Company conception.

Obtain financing create product, make sales.

Periods of incremental growth.

Value increases at inflection points

Exit strategy, find buyer, structure, negotiate and close transaction

Most Fair Vesting Formula

- Assuming that was the fundamental agreement,
- and that 50% of the value might be created at the exit,
- Then vest:
  - 50% of the shares daily over a three year period;
  - and the other 50% when there is a sale of the Company.
  - All vesting for senior employees accelerates on a sale of the Company.

Investment structure

- Most VCs still require pref shares.
- This can make sense for later stage companies and larger financings.
- Angels moving toward convertible notes.
- As protection against VC terms and structure.
- In my opinion, almost never fair to the angels.
- The fair ‘discounts’ would have to be much higher.

Exchangeable Shares

- Combines the best ideas in the convertible notes,
- With a more reasonable, and intuitive, pricing mechanism.
- The idea is simple:
  - Angels invest in commons shares (like we have always done)
  - At the pricing that makes sense at the time.
  - But if a VC comes along later and gets a better kind of shares, like prefs, we can convert into those shares to get the same benefits.
  - The pricing on our shares does not change, just the terms and conditions.

Putting it all together

- Require a good board that you can count on to make the right decisions.
- Structure the equity ownership fairly.
- With fair vesting applied to everyone.
- Invest in common shares – to keep it simple.
- With the right to exchange into prefs later, if someone else negotiates them.
- Along with a couple other standard provisions…

The One Page Term Sheet

- All of this can be done on one page (two sided with a cap table and signature blocks).
- I don't believe it has to be any more complicated than that.
- This is posted on Angelblog for everyone to use:
- www.angelblog.ca
- Please add your comments and suggestions.