Your First Financing Is The Most Important

New Ventures BC

May 21, 2008

By Basil Peters

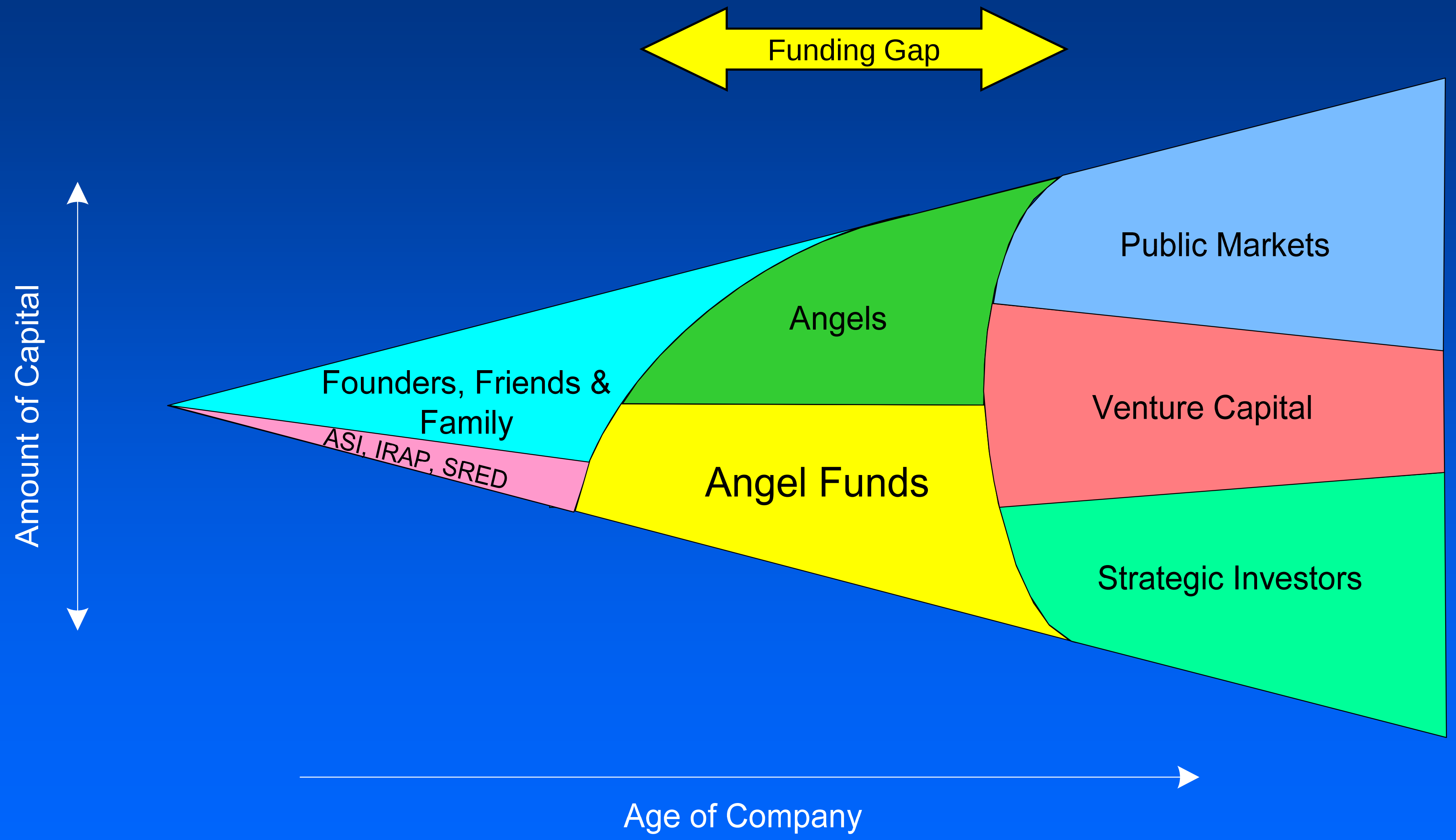
The Optimum Financing Path

- Over 90% of all young companies follow the same financing path:
  1. Friends and Family, then
  2. Angel Investors, then
  3. VCs or Public Venture Capital.

You can save a lot of time

- I didn’t know that when I was a young entrepreneur,
- Which is probably why our first external financing took 22 months to close.
- It is surprising how many entrepreneurs start by looking for “some venture capitalists” to fund their startup.
- VCs only fund about 2% of startups.

Sources of Capital



Amounts of Capital and Times

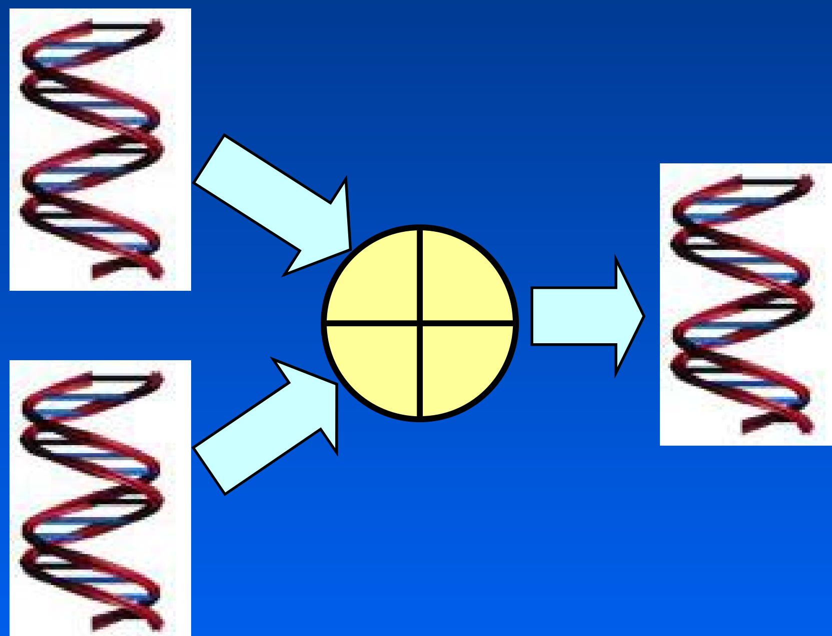
Round	Amount of Financing Available	Time to Complete
Friends and Family	$10k to $150k	1 to 2 months
Angels	$100k to $2 million	3 to 6 months
VCs	$2 million to <$20 million	6 to 12 months
Public Venture Capital	$1 million to $100 million	2 to 6 months

Adding Financial DNA

Your Entrepreneurial DNA

Combined with

The Investors' DNA



Resulting Corporate DNA is a Hybrid of Entrepreneurs' and Investors' DNA

Check the compatibility first

Quiz: Why are they investing?

- What is the most important reason they invest?
- Hint: This answer applies not just to the Friends and Family round but to all rounds.
- Expectation of a financial return?
- Because they like the business plan?
- The real answer –
- <u>Because they like you.</u>

The Good News

- The first rounds of financing are usually the easiest to do.
- The rounds are small
- Investors almost always know the entrepreneurs
- The business is usually ‘still on paper’
- So the financials look really great
- And everyone expects to make 100x on their investment.

The Problem Is

- Most of the people who invest in Friends and Family rounds,
- Really shouldn’t.
- Professional investors agree that the earliest rounds are actually the most difficult.
- Friends and Family investors almost never have the knowledge and skills to objectively evaluate:
  - Valuations
  - Structures
  - Market opportunities
  - Technology

Uh, Oh!

- These are our friends and family!
- And we really need their money.
- But don’t want to have awkward looks across the dinner table.
- So what should we do?

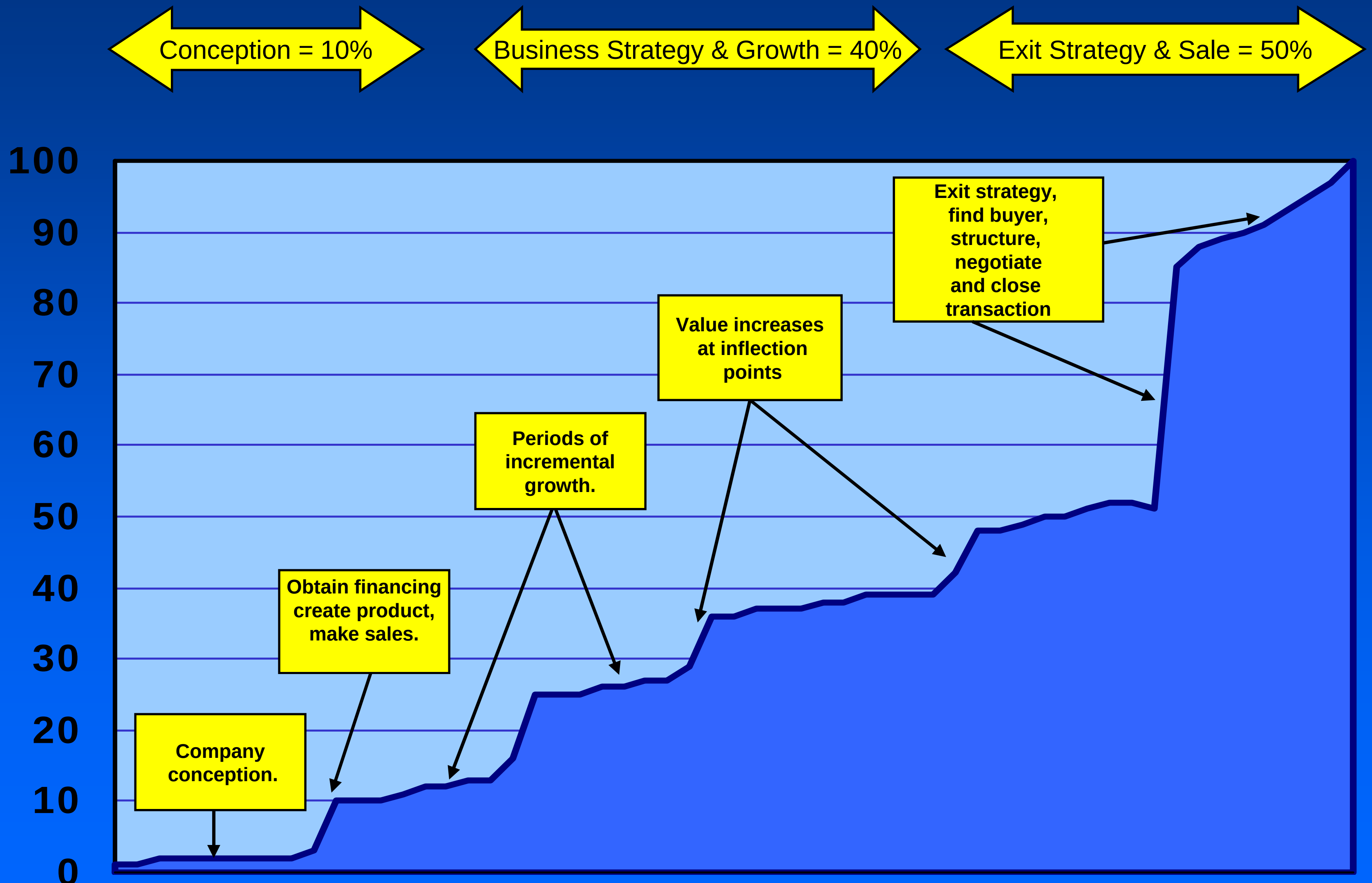
The Solution:

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

Structuring and 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.

Shareholder Value Creation



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.

Most Fair Vesting Formula

- Assuming that was the fundamental agreement,
- and that 50% of the value is typically 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.

Valuation

- Incredibly difficult to do for start ups.
- There are literally only a few papers written.
- Literally impossible to do quantitatively.
- More based on ‘gut’ and ‘instinct.’
- As much psychology as technology.
- There are probably only a couple of dozen people in most cities who have done it enough to be really good at it.

Valuation Guidelines

- There are some easy guidelines:
- For pre-revenue companies without extensive patent portfolios,
- Friends and Family round valuations are usually in the range of $0.5 to 1 million.
- The next round investors, the Angels, should be investing at valuations of $1 to 3 million.
- Friends and Family may be willing to pay more.
- But DON’T LET THEM!

Structuring - KISS

- In the 1990’s some investors developed ever more complicated preferred shares and definitive agreements.
- Created fundamentally flawed relationships between the entrepreneurs and investors.
- Today, there is an encouraging move back to common shares.
- And keeping it simple.
- And fair.

Fairness

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

Alignment

- Means that everyone is working toward the same objective.
- The starting place is everyone having the same type of financial interest.
- Mis-alignment 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.
- <u>Just say "No" to prefs, royalties and debt.</u>

Corporate Governance

- Probably the biggest change for early-stage companies – especially over the past few years.
- Corporate Governance will continue to increase in importance for many years.
- Enormous topic – would also take a three days seminar to do justice to.
- Today, a real board is important from the very earliest days.

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 should be acceptable to the CEO and investors.

Harder to attract good directors

Business in Vancouver February 18–24, 2003

Insurance hikes force lawyers off boards

Clark Wilson discourages appointments; partner off DataWave board

Tracy Tjaden

U.S. corporate governance scandals have pushed insurance rates sky-high, forcing one Vancouver law firm to discourage its lawyers from sitting as directors of public companies.

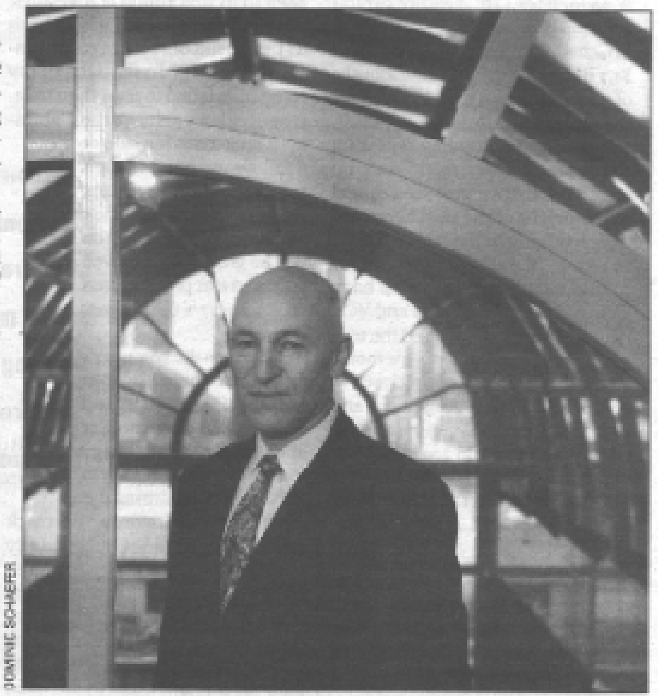
Bernard Pinsky, a partner of corporate law firm **Clark, Wilson**, resigned from Vancouver-based **DataWave Systems Inc.**'s board of directors February 7.

In total, Clark, Wilson lawyers have resigned from half a dozen boards in recent months.

Two years ago, its lawyers sat on about 25 boards of public companies, Pinsky said. The firm's lawyers are in the process of resigning from all pubic company boards.

The firm's insurance costs for directors' and officers' liability insurance shot up 150 per cent this year over last year. That's after a 75-per-cent increase last year over the year before.

"It's the big corporate governance failures in the U.S. that have driven rates up because [the insurance companies] are paying out billions," said Pinsky.



DOMINIC SCHAEFER

Resigned: Lawyer Bernard Pinsky left DataWave board due to insurance costs

Director Time Commitment

- The minimum time required is directly related to how fast the company is changing.
- A board for a single property real estate company might be able to do a good job in one half a day per quarter.
- A lead director for an early-stage, high-growth technology company might need a day per week, or even more.

Director Compensation

- The board you need will dramatically increase your success.
- Your directors will have to make a significant time commitment,
- And accept very real personal risk.
- The company has to compensate them fairly.
- Rule of thumb: the total compensation for the outside directors should equal the CEO's – including cash and equity.

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.

Advisory board is not the same

- No, an advisory board won’t do.
- If you can’t get a good board committed,
- Do you really think its fair to ask someone to invest?
- Good news is that early-stage funds and angels will often help you build a good board.

Can we just take their money?

- I often see companies that have raised money from several friends and family members,
- That do not have any reasonable documentation of their corporate structure, share register, financing exemptions or subscription agreements.
- Some of these are legal requirements.
- BC Securities Commission is increasing enforcement.
- You need some legal advice before you take money from friends and family.

Putting it all together

- Recruit a good board early that you can count on to make the right decisions.
- Find some really good mentors.
- Structure the equity ownership fairly.
- With optimum vesting applied to everyone.
- Use only common shares.
- Keep it simple and fair.
- Be sure its properly documented.

Summary

- There is a lot more to doing this successfully, than can be summarized in a PowerPoint.
- You need Mentors and people who have done it.
- Lots of good resources online and in Vancouver:
- www.AngelBlog.net
- For a copy of this presentation:
- www.BasilPeters.com/Speaking_Engagements.html
- Thank you.

Good Luck!