

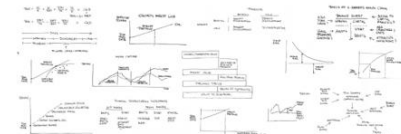
COPY OR PASTE

WORKING WITH INTERNATIONAL VENTURE CAPITAL FUNDS

PERSONAL OBSERVATIONS

2019

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Corporate Finance Concepts

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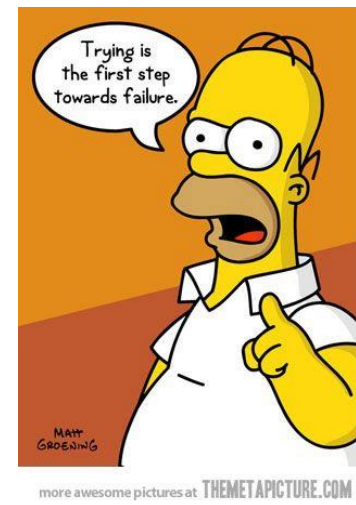
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Following is a Good Start

- Make cold calls
 - ... this is the hottest thing on earth!
- Don't prepare anything
 - ... nobody is cooler out there
- Always insist on NDAs
 - ... all top secret, man!
- Valuation is value
 - ... \$\$\$ is all what counts
- Term sheet? What term sheet?
 - ... this is just dry lawyers' stuff
- Here are my terms
 - ... you want me to negotiate?
- Reject a rejection
 - ... and ideally shout at them!



Why Start-Ups Fail



What Makes Your Proposition a „Hot One“ ...

- Proven team with a great **track record**
- Outstanding **metrics**
- **Unique** technology or distribution advantage
- **Other VC** firms are ready to invest
- A warm **intro**
- You are in a **VC-hyped category**
- Your company **fits** the VC's investment thesis perfectly

Before Working with VCs

- The mechanics of the VC model
 - Most VCs are **intermediaries**
 - Some platforms invest their own money
- The most relevant **values** to expect from VCs
 - Money
 - Expertise / knowledge
 - Network / mentorship
 - Operational support
 - Branding

Is the VC model aligned with your aspirations as an entrepreneur, or rather not?

Preparing for Fundraising

- **Shortlist** of relevant VCs
 - Investment stage
 - Seed, series A, B, C...
 - Investment scope
 - Investment thesis
 - Blogs, latest deals
 - “Value added” / operational support
 - Expertise in your area?
 - Any successes?
 - Fund size?
 - Stage in their life cycle?
- First “light” **reference** checks
 - Other founders
 - Business angels
 - Incubators and accelerators
- Create fundraising **material**
- Contact

The Relationship with a VC

- Your company is the product ...
- ... and you're **selling an equity ownership** in your company ...
- ... **but** actually you are selling trust & confidence that you are going to **build something enormously valuable** ...
- ... and that you're going to be enjoyable to work **hand-in-hand** with **over the coming decade** of each other's lives

This actually sounds more scary than entering a marriage ...

The VC Machine

- Partnership
 - **Number** of partners
 - Active and less **active** partners
 - Who has “**pull**” to get deals done
 - Which partners work well with which other partners
 - Who are the more **optimistic** partners ...
 - ... and who are the most generally skeptical ones
 - How does the partnership typically make its final **investment decisions**
- Non-Partner Investment Staff
 - Sourcing deals for partners
 - Initial deal screening with a partner
 - Assisting with due diligence
 - Building models to evaluate the deal
 - Completing due diligence post partner meeting for questions raised there

The Pitch

- Know your **audience**
 - Who are you meeting with?
- Briefly warm up, then straight to the point ...
 - The succinct tagline
- The **numbers**
 - If you have strong metrics, then bring this up early and be specific
 - If your metrics are weak, focus on how massive the problem is...
- The story of the **growth** potential
 - ... supported by market metrics
- The product **story**
- The product **value**
 - Its benefits and features
- **How** do you intend **to make money**
 - What makes you better than your competition
 - How are you monetizing
 - Are you already profitable
- Your **team**
 - ... in times of trouble ...

The Pitch Book

- From a long-form to the elevator pitch ...
- Of Power Point presentations which are too long ...
- Excellent Executive Summary
 - The **problem** the startup will be **solving**
 - The **size of the market** the startup will be addressing
 - The sustainable **competitive advantage**
 - The expected **revenues and costs** of the startup
 - ... supported by realistic and detailed assumptions and projections
 - Description of the startup's management **team**
 - **Exit** for the investors



How VCs Assess Opportunities

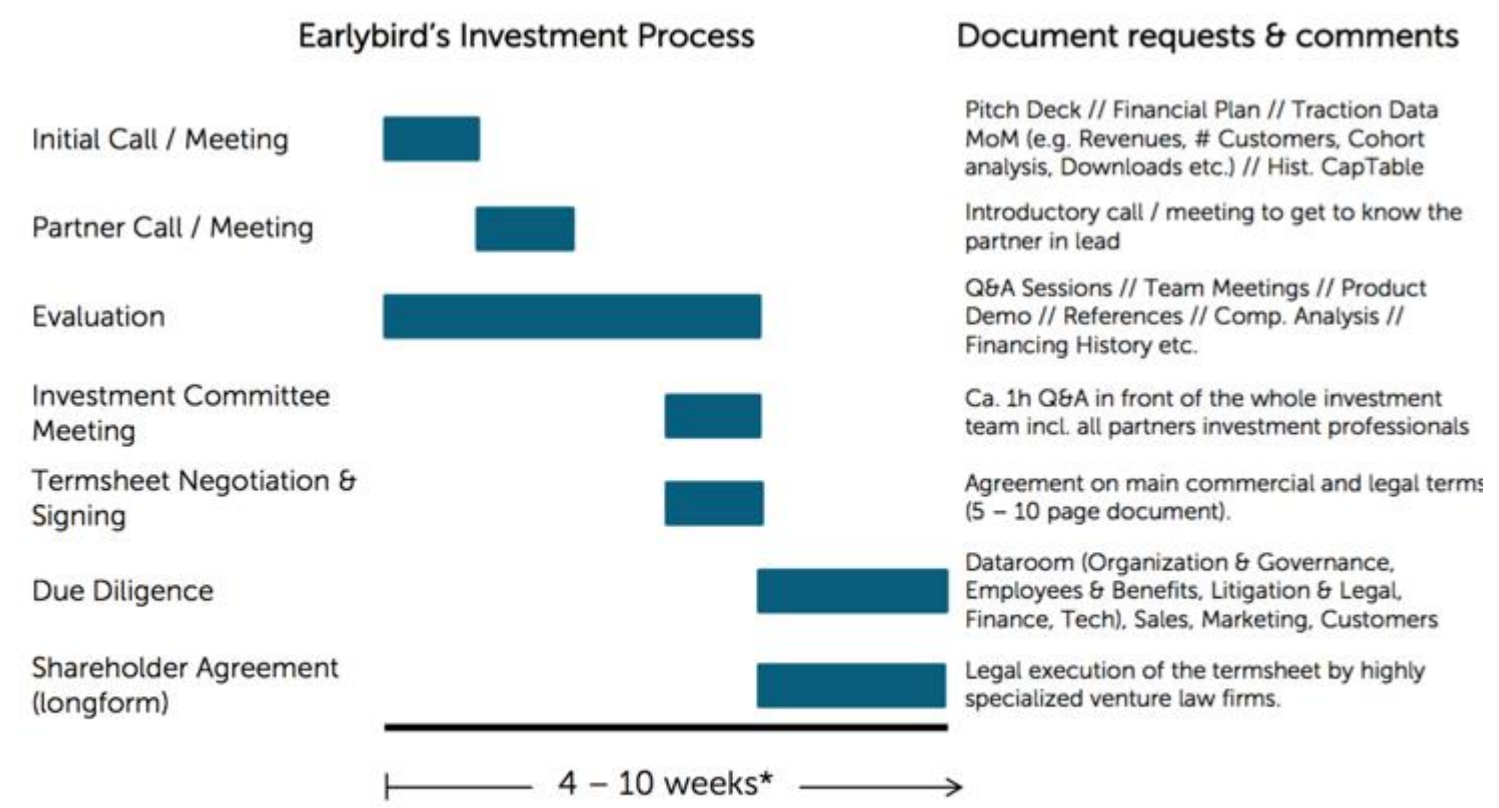
- An analyst / associate / principal check whether proposal in line with VC's **investment scope & thesis**
- If promising
 - **Internal discussion**
 - Partners
 - Investors
 - Experts
 - ...
 - Deal Memo
- **Iterative, ongoing decision making**
 - Unanimity from all the partners
 - Certain percentage
 - “Super user” partner / veto
 - Sponsoring partner ownership
 - ...
- Observations
 - VCs are **conviction** driven
 - Almost certainly no deal, if even one partner has deep conviction “against” a decision
 - Frequently, partner have **equal say**
 - Input from board partners and non-partner investment staff
 - Policy of “**no retribution**” and “**no reciprocity**”
 - Decision making can be draining

Feedback Alternatives

- **No**, not interested ...
 - Should I be mad?
 - Should I ask why?
 - I really want this investor with me: Should I insist?
- We're **looking** at you / **into it** ...
 - If your company is “hot”, you'll probably meet a Partner quickly
 - If not, you'll probably interact multiple times with associates or principals first
 - If the investors need to build conviction, they'll ask you for more material
- You **don't receive** any **answer**
 - Not convinced enough to explore the opportunity in more depth
 - Currently under water and having other priorities
 - Forgot about you
 - It's a bad VC ...



Indicative Timetable



* Note: The timeline is only an approximation to give you a high level overview of our processes.

The Term Sheet

- **Non-binding** document ...
- ... meant to record two or more parties' **intentions** ...
- ... to enter into a **future** agreement ...
- ... based on specified - but **incomplete** or preliminary - terms

Thoughts on Term Sheet Negotiation

- **Listen!**
- VC attention and support are **limited** resources
- Entrepreneurial overconfidence
- Your **leverage** is not only a function of your alternatives
- **Transparency** is often less costly than one may fear
- Building **trust** is most easily when the other party is vulnerable
- The allure of valuation
- The wise power of **bargaining**
- The **terms the VC accentuates**

Due Diligence is a Two-Way Street

- Ask on certain VC **aspects** which are important for you
 - Concrete **examples**
- Cross-reference checks with **founders of their portfolio**
 - Ask for introductions to the ones you want to talk to
- Ask yourself whether you **trust** the individuals you've been interacting with during the overall process
- Ask the VCs **what** they do **when a portfolio company doesn't do well**

Thoughts on Valuation



Valuation Aspects

- **Experience** and past success of the founders
 - “Serial” entrepreneurs present less risk, often command higher valuations
- The size of the market **opportunity**
- **Proprietary** technology already developed
- Any **initial traction**
 - Revenue, partnerships, satisfied customers, favorable publicity, etc.
- Progress towards a minimally **viable product**
- **Recurring revenue** opportunity
- **Capital efficiency** of the business model
 - Will the company need to burn through significant capital before reaching profitability?
- Valuations of **comparable** companies
- Whether the company is “hot”
 - ... and **pursued by other investors**
- The current **economic climate**
 - Valuations generally climb when the overall economy is strong

Post-Investment

- **Interaction** with investors
 - Recurring: **Board Meetings**
 - Keep the board members informed of the company's progress
 - Discuss short and long term plans
 - Take decisions that require the approval of the board members
 - Recurring: **Check-ins**
 - One-time interactions
 - Feedback sessions
 - Recruiting
 - Raising your next round
 - Portfolio events
 - Portfolio platform / online groups
- Optimize investor relationship
 - Set **expectations**
 - “Hands-on” type or very light?
 - Founding team “weaknesses” that could be filled by investors knowledge (education) or network (hiring)?
 - Demand for industry specific knowledge or specific value add that investors offer
 - Understand investor's profile / **strengths**
 - **Pro-active & structured approach**
 - Provide all required information upfront
 - Clear call to action
 - Not at the last second and share a deadline

When Things Go Wrong

- **Good VCs will help** you, if your company is not doing well ...
- ... while **bad VCs will screw you up**

In Conclusion

- Act greedily
- Be close-minded
- Ask for too little
- Cover your passion
- Don't have a solid plan

Selected Term Sheet Aspects

Selected Term Sheet Aspects

- **Form of the Venture Capital Investment**

- Convertible promissory note
 - Convertible into company stock in its next round of financing at a discount (eg 20%)
 - Maturity date (often 12 months from issuance) and will bear interest (4% to 8% is common)
 - No valuation is set for the company at this time.
 - Sometimes with “cap” on the valuation for purposes of the conversion rate
 - Quick and easy to document
- Convertible preferred stock
 - Rights, preferences and privileges set forth in the company’s certificate of incorporation
 - Preference over common shareholders on a sale of the company
 - Upside potential of being able to convert to common stock of the company
 - Most Series A financing rounds are done as convertible preferred stock

- **Vesting of Founder Stock**

- Vesting credit for time already served with the company?
- Vesting schedule of less than (usual) 48 months? No schedule?
- Accelerated vesting accelerate, (employment termination; sale of the company)?

Selected Term Sheet Aspects (cont'd)

- **Composition of the Board of Directors**
 - Allocation usually follows share ownership
 - Illustrative scenarios
 - 3-person Board, with two chosen by the founders, and one chosen by the investors
 - 3-member Board, one chosen by the founders, one chosen by the investors, and one independent director mutually agreed upon
 - 5-member Board, two chosen by the founders, two chosen by the investors, and one independent director mutually agreed upon
- **Liquation Preference of the Preferred Stock**
- **Participating vs. Non-Participating Preferred**

Selected Term Sheet Aspects (cont'd)

Participating liquidation preference

- Investor invested \$1M in a \$6M pre-money valuation (\$7M post) with a 2x participating liquidation preference
 - Investor owns 14.4% ($\$1M/\$7M$) of the company and would get upside on any change of control
- If the company sold for \$15M the investor would get back 2x of their investment first for \$2M ($2 \times \$1M$) and ...
- ... the rest of the remaining \$13M ($\$15M - \$2M$) would be distributed among all shareholders
- Investor hence receives an additional \$1.9M ($14.4\% \times \$13M$), a total of \$3.9M ($\$2M + \$1.9M$)

Non-Participating liquidation preference

- Investor has a 2x non-participating liquidation preference and a 14.4% ownership of a \$7M post-money valuation
- If the company is sold for \$15M, the investor would have a choice of **either** receiving \$2M ($2 \times \$1M$) for their liquidation preference ...
- ... **or** \$2.2M ($14.4\% \times \$15M$) for its participation, therefore \$2.2M

Selected Term Sheet Aspects (cont'd)

- **Protective Provisions / Veto Rights of the Investors**
 - Amendment of the company's charter or bylaws to change the rights of the preferred
 - Creation of any new series or class of shares senior to, or on parity with, the preferred
 - The sale or liquidation of the company
 - Payment of dividends
- **Anti-Dilution Protection**
- **Right to Participate in Future Financings**
- **Stock Option Issues**
 - Venture investors will want to ensure that the company has a stock option pool for future equity grants, typically 10% to 20% of the company's capitalization, with later-stage companies having smaller pools

Selected Term Sheet Aspects (cont'd)

- **Redemption Rights**
 - Investors may, by majority vote at any time starting five years after their investment, elect to be redeemed (repurchased at their original purchase price), with payments made over a three-year period in equal installments
- **Information Rights**
- Insurance Obligations
- Rights of First Refusal/Co-Sale Rights
- Drag-Along Rights
- Registration Rights
- Exclusivity/No Shop
- Confidentiality
- Dispute Resolution
- Due Diligence by VC Investors

Selected Legal Documents



Voting Agreement



Term Sheet



Stock Purchase Agreement



Right of First Refusal and Co-Sale Agreement



Model Legal Opinion



Management Rights Letter



Investor Rights Agreement



Indemnification Agreement



Certificate Of Incorporation

Excursion – Valuation of Startups

Standard Forecast

| Year | | 0 | 1 | 2 | 3 | 4 | Residual |
|-----------------------|-------|-------|-------|-------|------|------|----------|
| Cash Flow Forecast | | -5,00 | -7,00 | -2,00 | 0,00 | 5,00 | 10,00 |
| Unadjusted Cash Flows | | | | | | | |
| Discount Factor | 30,0% | 1,00 | 0,77 | 0,59 | 0,46 | 0,35 | Sum |
| Discounted Cash Flows | | -5,00 | -5,38 | -1,18 | 0,00 | 1,75 | -9,82 |
| Terminal Value | | | | | | | |
| Growth | 2,0% | 35,71 | | | | | |
| Dicounted TV | | 12,50 | | | | | |
| Enterprise Value | | 2,69 | | | | | |

Forecast with Survival Probability

| Year | | 0 | 1 | 2 | 3 | 4 | Residual |
|--|-------|--------|-------|-------|-------|-------|----------|
| Cash Flow Forecast | | -5,00 | -7,00 | -2,00 | 0,00 | 5,00 | 10,00 |
| Probability of Success of Previous Stage | | | 40,0% | 60,0% | 80,0% | 90,0% | 95,0% |
| Cumulative Probability of Survival | | 100,0% | 40,0% | 24,0% | 19,2% | 17,3% | 16,46% |
| Probability-adjusted CF Forecast | | -5,00 | -2,80 | -0,48 | 0,00 | 0,86 | 1,65 |
| Adjusted Cash Flows | | | | | | | |
| Discount Factor | 12,0% | 1,00 | 0,89 | 0,80 | 0,71 | 0,64 | Sum |
| Discounted Cash Flows | | -5,00 | -2,50 | -0,38 | 0,00 | 0,55 | -7,33 |
| Terminal Value | | | | | | | |
| Growth | 2,0% | 16,46 | | | | | |
| Discounted TV | | 10,46 | | | | | |
| Enterprise Value | | 3,13 | | | | | |

Valuation Approach – Year 0

| Year | | 0 | 1 | 2 | 3 | 4 | Residual |
|--|-------|--------|-------|-------|-------|-------|----------|
| Cash Flow Forecast | | -5,00 | -7,00 | -2,00 | 0,00 | 5,00 | 10,00 |
| Unadjusted Cash Flows | | | | | | | |
| Discount Factor | 30,0% | 1,00 | 0,77 | 0,59 | 0,46 | 0,35 | Sum |
| Discounted Cash Flows | | -5,00 | -5,38 | -1,18 | 0,00 | 1,75 | -9,82 |
| Terminal Value | | | | | | | |
| Growth | 2,0% | 35,71 | | | | | |
| Dicounted TV | | 12,50 | | | | | |
| Enterprise Value | | 2,69 | | | | | |
| | | | | | | | |
| Year | | 0 | 1 | 2 | 3 | 4 | Residual |
| Cash Flow Forecast | | -5,00 | -7,00 | -2,00 | 0,00 | 5,00 | 10,00 |
| Probability of Success of Previous Stage | | | 40,0% | 60,0% | 80,0% | 90,0% | 95,0% |
| Cumulative Probability of Survival | | 100,0% | 40,0% | 24,0% | 19,2% | 17,3% | 16,46% |
| Probability-adjusted CF Forecast | | -5,00 | -2,80 | -0,48 | 0,00 | 0,86 | 1,65 |
| Adjusted Cash Flows | | | | | | | |
| Discount Factor | 12,0% | 1,00 | 0,89 | 0,80 | 0,71 | 0,64 | Sum |
| Discounted Cash Flows | | -5,00 | -2,50 | -0,38 | 0,00 | 0,55 | -7,33 |
| Terminal Value | | | | | | | |
| Growth | 2,0% | 16,46 | | | | | |
| Dicounted TV | | 10,46 | | | | | |
| Enterprise Value | | 3,13 | | | | | |

Valuation Approach – Year 1

| Year | | 0 | 1 | 2 | 3 | 4 | Residual |
|--|-------|-------|--------|-------|-------|-------|----------|
| Cash Flow Forecast | | | -7,00 | -2,00 | 0,00 | 5,00 | 10,00 |
| Unadjusted Cash Flows | | | | | | | |
| Discount Factor | 30,0% | | 1,00 | 0,77 | 0,59 | 0,46 | Sum |
| Discounted Cash Flows | | | 0,00 | -5,38 | -1,18 | 0,00 | -6,57 |
| Terminal Value | | | | | | | |
| Growth | 2,0% | 35,71 | | | | | |
| Discounted TV | | 16,26 | | | | | |
| Enterprise Value | | 9,69 | | | | | |
| | | | | | | | |
| Year | | 0 | 1 | 2 | 3 | 4 | Residual |
| Cash Flow Forecast | | | -7,00 | -2,00 | 0,00 | 5,00 | 10,00 |
| Probability of Success of Previous Stage | | | | 60,0% | 80,0% | 90,0% | 95,0% |
| Cumulative Probability of Survival | | | 100,0% | 60,0% | 48,0% | 43,2% | 41,14% |
| Probability-adjusted CF Forecast | | | -7,00 | -1,20 | 0,00 | 2,16 | 4,11 |
| Adjusted Cash Flows | | | | | | | |
| Discount Factor | 12,0% | | 1,00 | 0,89 | 0,80 | 0,71 | Sum |
| Discounted Cash Flows | | | -7,00 | -1,07 | 0,00 | 1,54 | -6,53 |
| Terminal Value | | | | | | | |
| Growth | 2,0% | 41,14 | | | | | |
| Discounted TV | | 29,28 | | | | | |
| Enterprise Value | | 22,75 | | | | | |

Excursion – On Negotiation

The Fog of War

The Fog of War: Eleven Lessons from the Life of Robert S. McNamara

- Empathize with your enemy
- Rationality will not save us
- There's something beyond one's self
- Maximize efficiency
- Proportionality should be a guideline in war
- Get the data
- Belief and seeing are often both wrong
- Be prepared to re-examine your reasoning
- In order to do good, you may have to engage in evil
- Never say never
- You can't change human nature



The 14 Basic Child Negotiation Skills

- Throw a tantrum



- Ask the person who's most inclined to say "yes"

- Play one side against the other

- Get sympathy



- Take your time

- Change the rules

- Solicit a bribe

- Wear the other side down

- Turn the negotiations into a game

- Act irrationally

- Worry the other side that you might be sick

- Make weak promises

- Win through cuteness



- Take your toys and go home

Key Questions in Negotiations

1. BATNAs

- What if no agreement?

2. Parties

- Who are the real parties in the negotiation?

3. Interests

- What are fundamental needs / priorities?

4. Value

- How to create value / Who is likely to get it?

5. Barriers

- What obstacles might prevent agreement?

6. Power

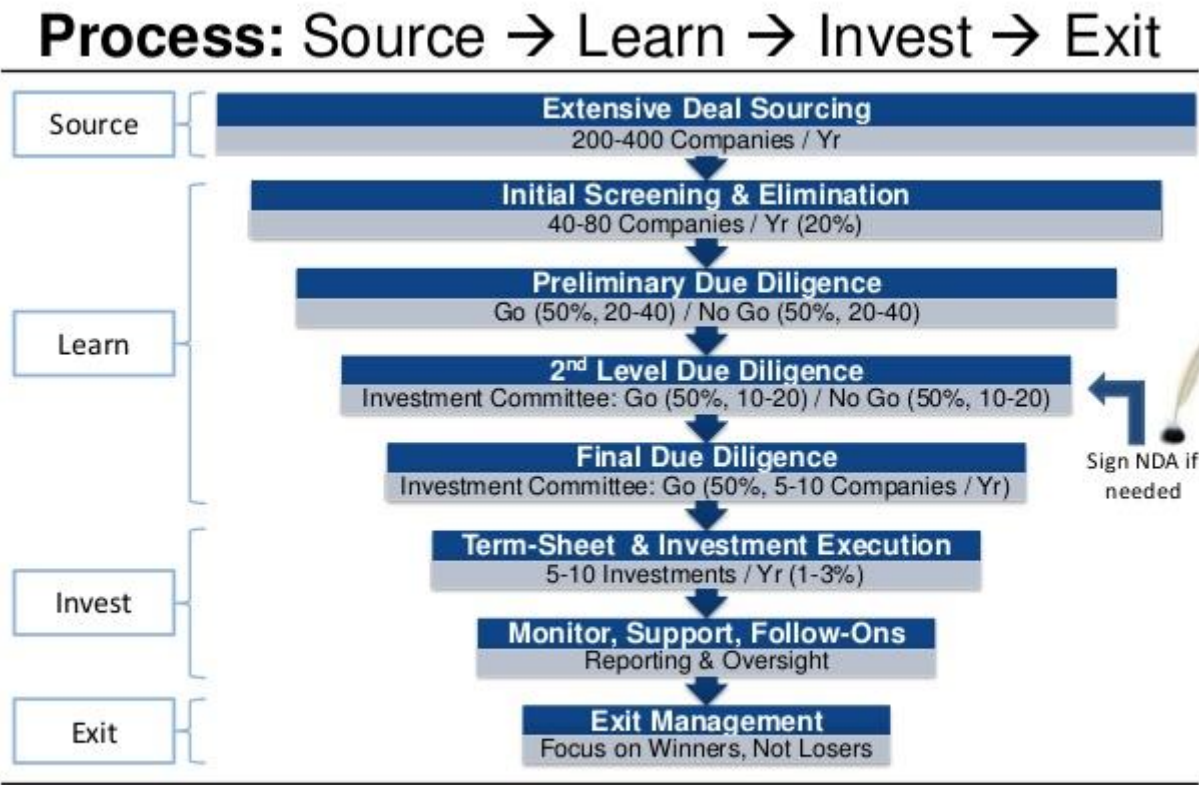
- Parties' influence on negotiation process

7. Ethics

- What is the right thing to do?

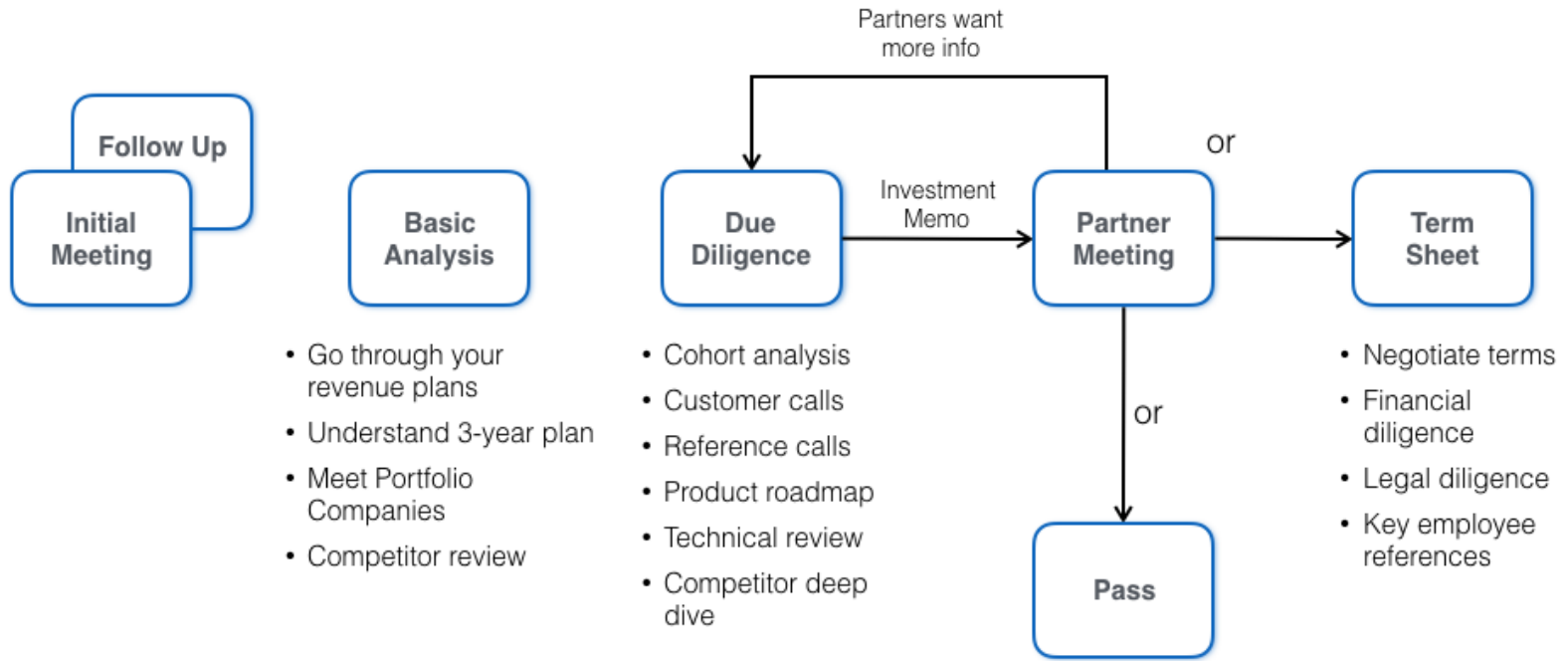


Appendix

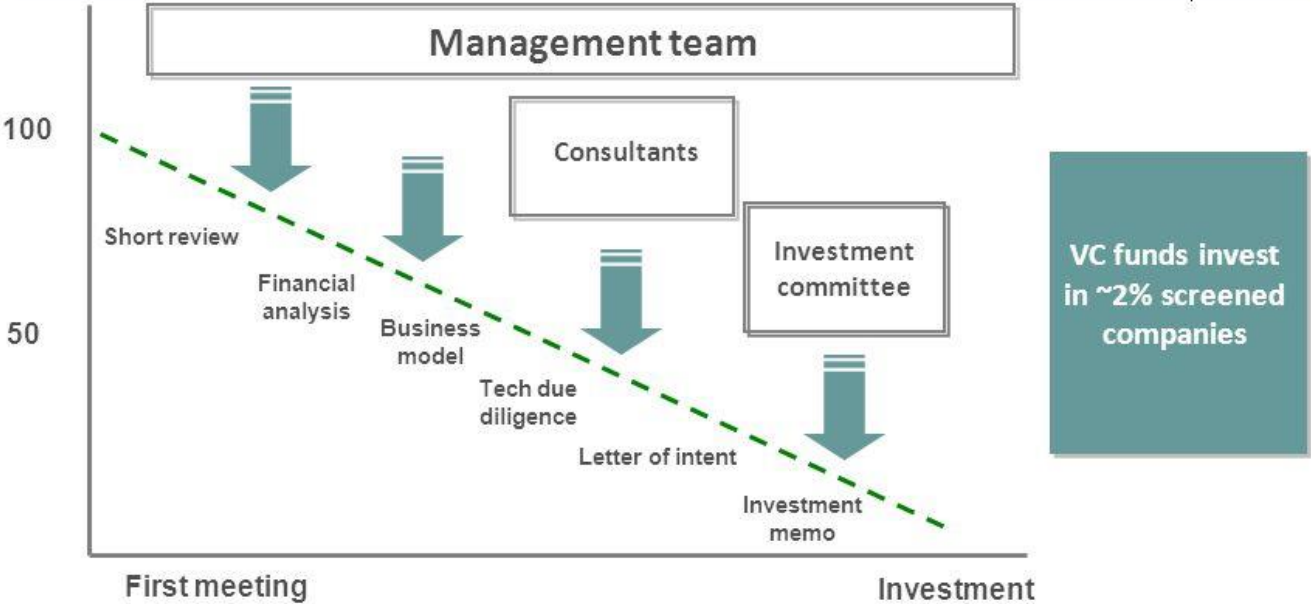


WASTE

Typical VC Process



From presentation to investment



Investment process usually lasts from 4 to 9 months

LCM

Quotes

First-time founders have the job security of zero-hour contract workers, the money worries of chronic gamblers and the social life of hermits

“The minute you think that the past was better, your present is second hand, and yourself becomes vintage. It’s OK for clothes, not that great for people.”

Karl Lagerfeld

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