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*is pleased to present*



# From THE MIND OF THE INVESTOR™ series

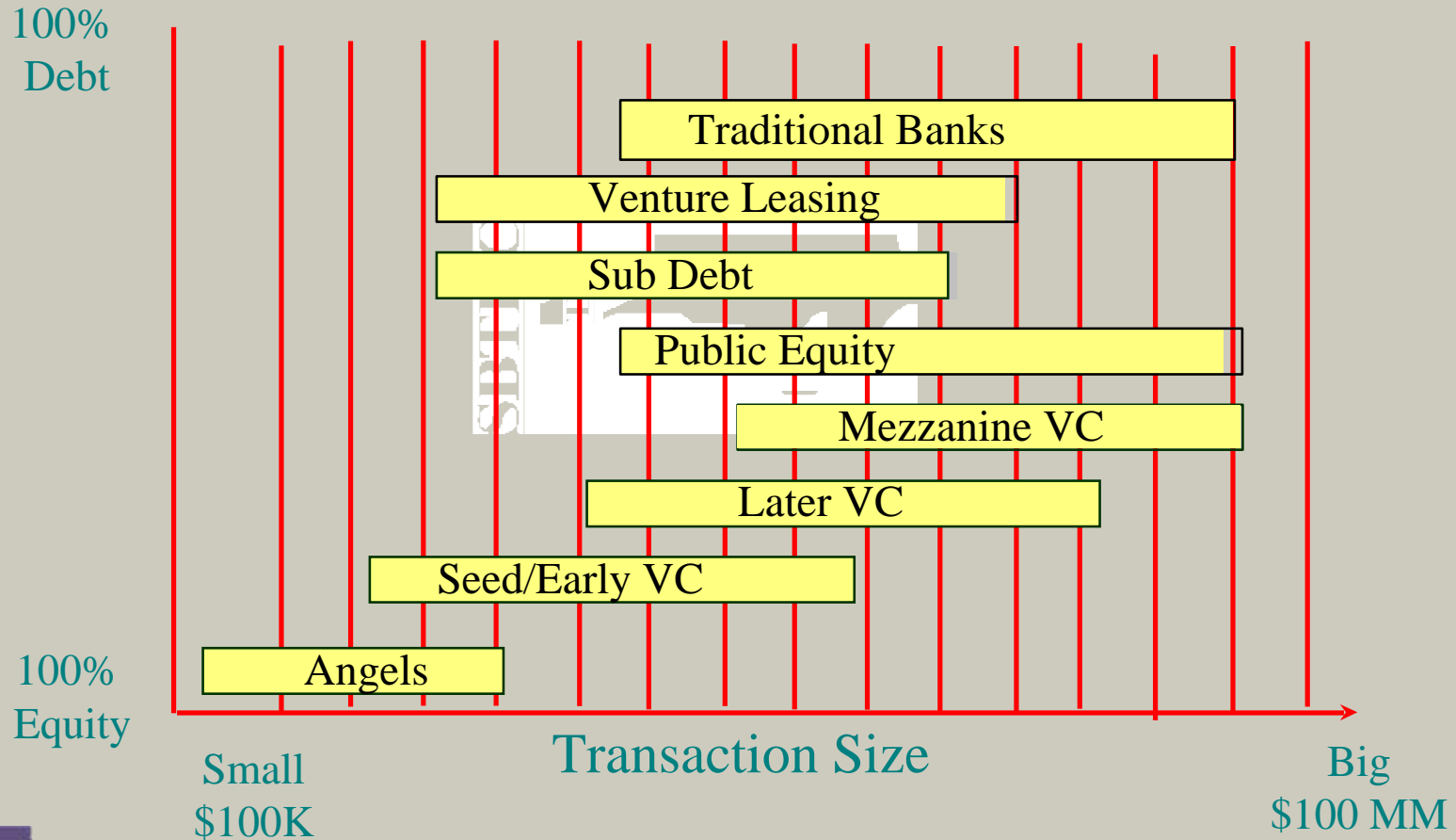
UNC Pembroke Entrepreneurial Summit  
March 12, 2009  
VENTURE CAPITAL

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# The Funding Landscape – Debt and Equity

Source: Garheng Kong, Intersouth Partners

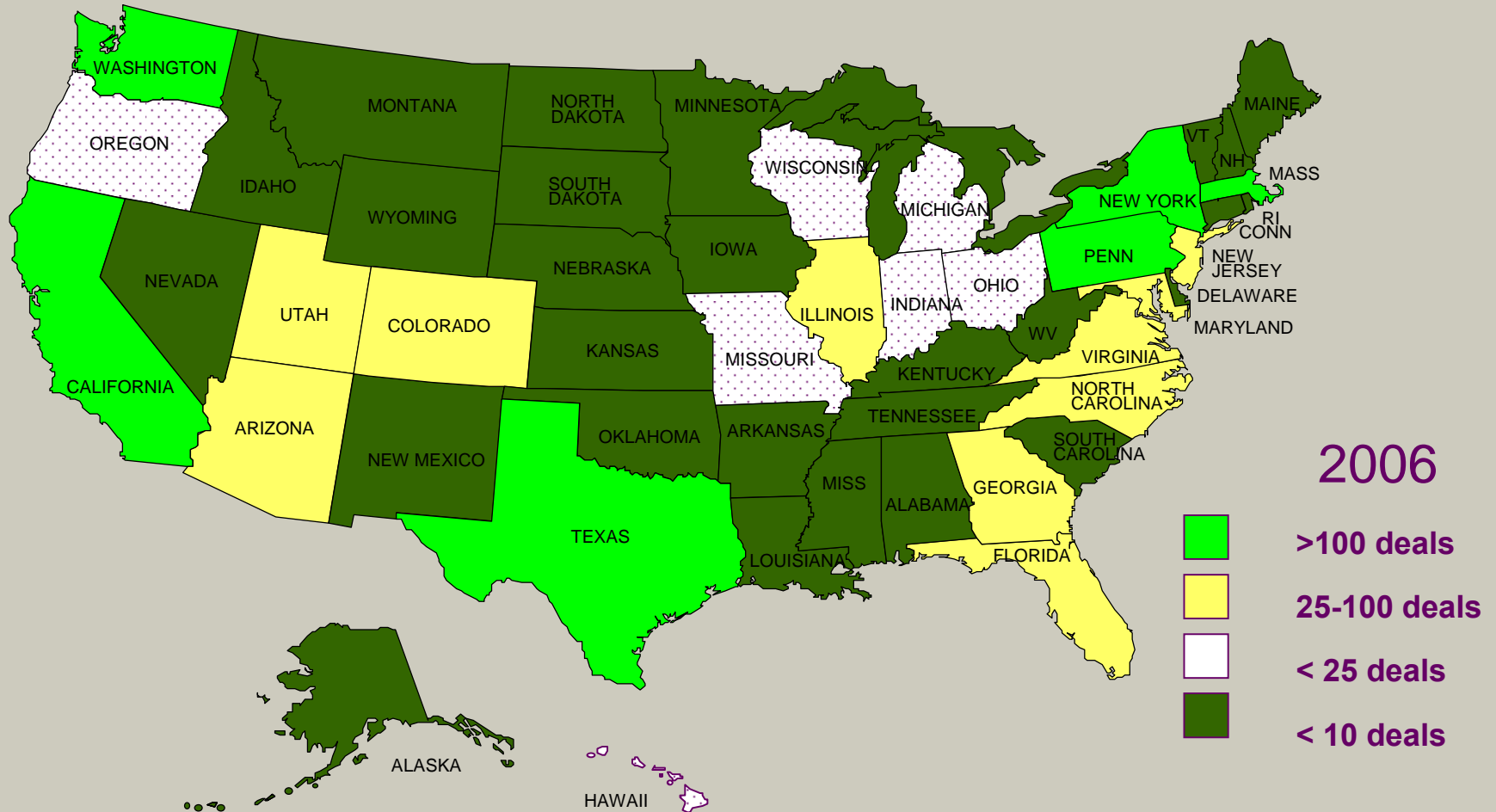


# Angels and VCs

Source: Kauffman Foundation & Center for Venture Research (CVR)

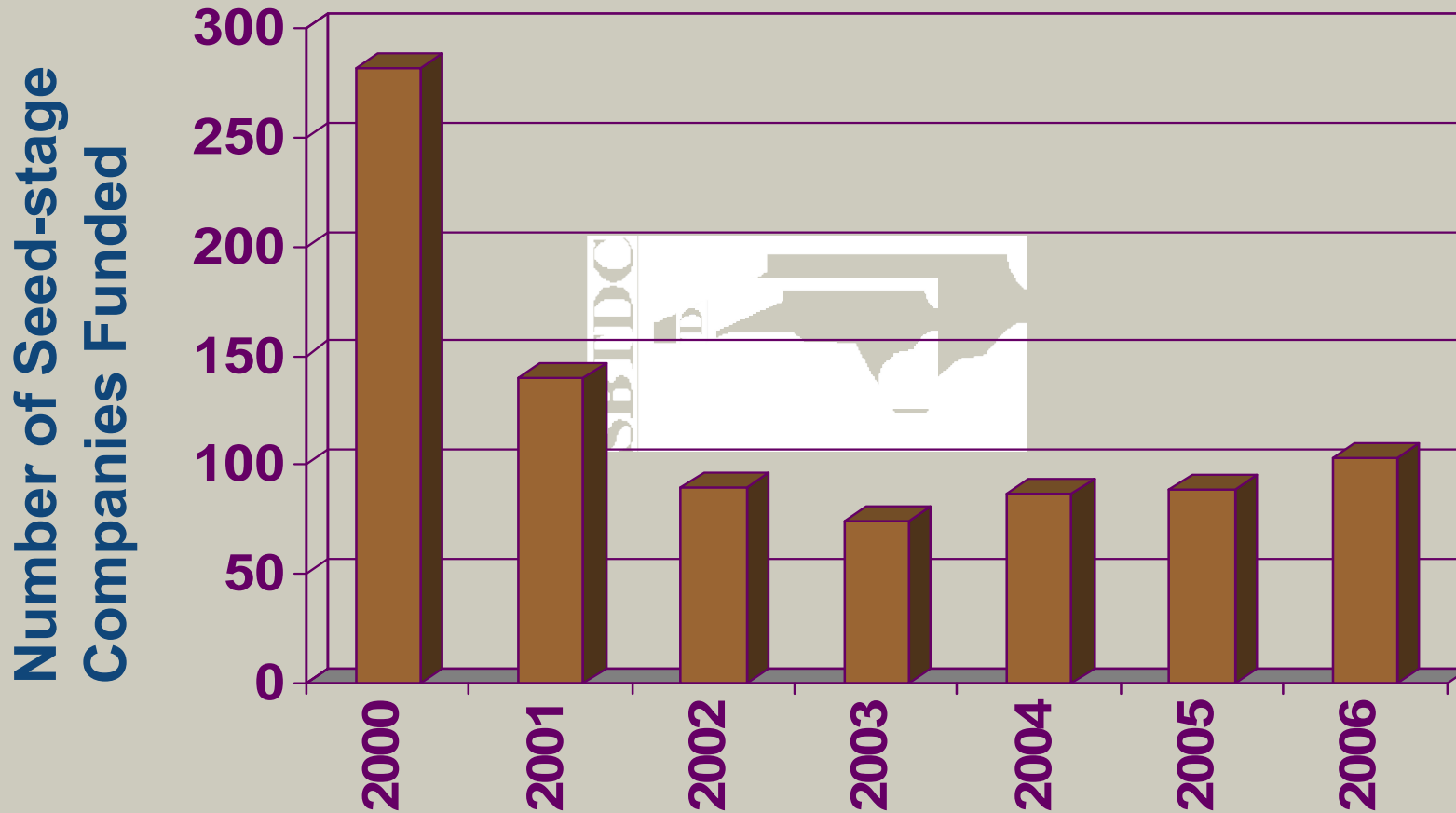
	<u>Angels</u>	<u>VCs</u>
Amount of Capital	~ \$26 billion (2007)	\$26.5 billion (2007)
Number of Investors	250,000	<900
Number of Investments	57,000	2,500 (~200 seed)
Per round	\$0.50 million	\$7-8 million
Investors per round	6 - 10	2 - 3
Professionally managed	Sometimes	Yes
Motivation	Various	ROI first

# VC Deals by State



Source: Kauffman Foundation – “Power of Angel Investing”

# VCs Funding Fewer Seed-Stage Companies



Source: VentureOne

# VC Expectations – *The Plan*

- Provide a range of financial outcomes ( low to high)
- Make the plan realistic and believable
- Know the dynamics – what affects your plan?
- Addressable market - know it from the bottom up
- Positioning and competition – where and who?
- Backup plan – Survival is the key
- Exit plan – Where do you get off the train?
- Concise format – use words carefully

# Why VCs Turn Down Deals

- Quality of Management
- Size of Opportunity
- Rate of Market Growth
- Product Quality
- Competition
- Barriers to Entry
- Stage of Development

# Key Questions for dealing with VCs

- What are the factors in valuing the company?
- What *is* vs What *might be*
- Overview of methodologies
- Revenue vs pre-revenue
- What about multiples?
- What resources are available for use in valuation?
- Shouldn't I be compensated for my sweat equity?
- Opinion of value vs negotiating skills vs the market
- An example



# Overview of Methodologies

...for acquisition of ongoing firms...

- Book Value – Assets less Liabilities – *limited use*
- Market Value – comps of similar investments
- Income Value – free cash flows, discounted
- Average of relevant methods – weighted as appropriate

# But what about early-stage ventures?

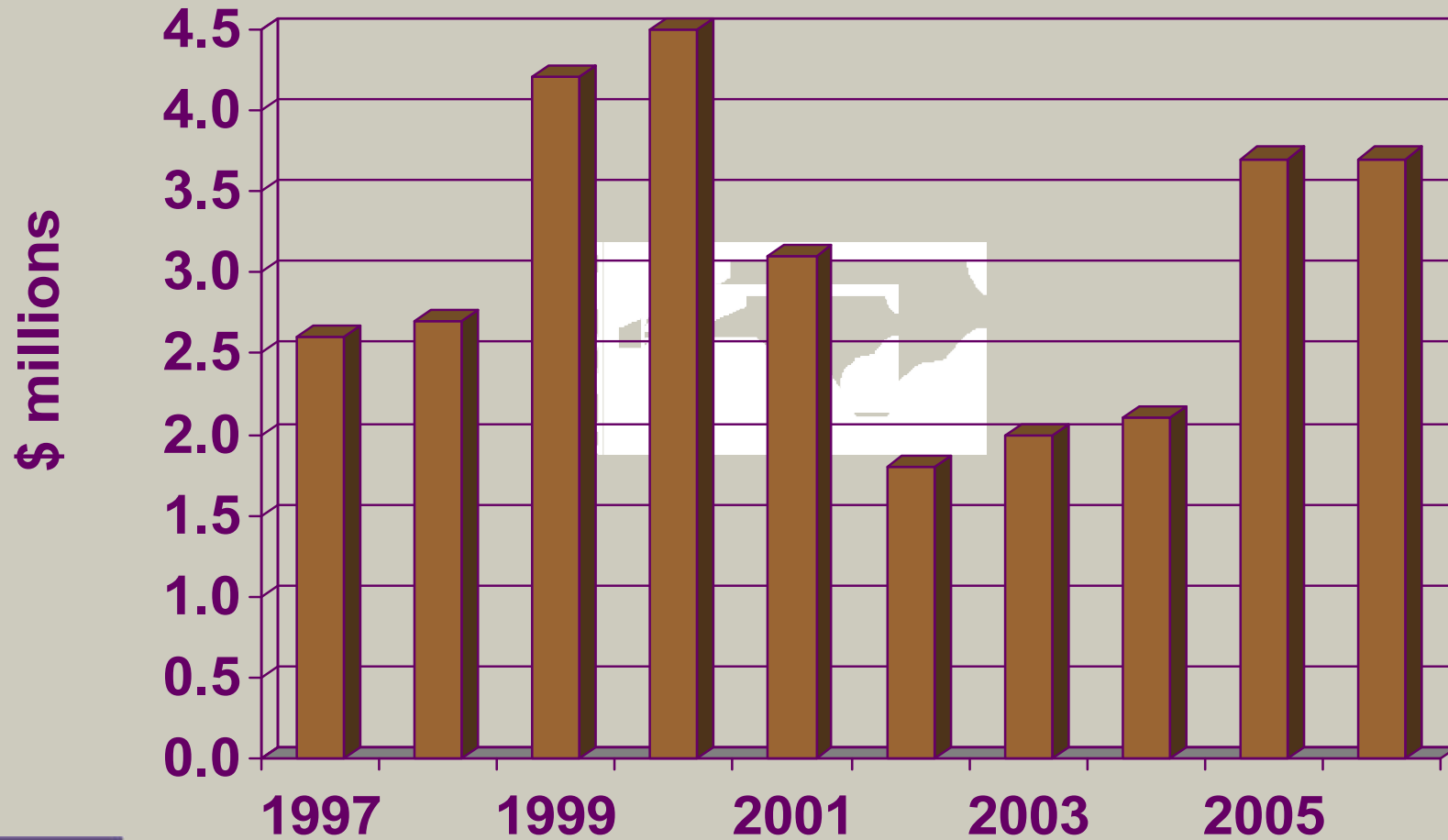
Remember, they have

- Limited track record
- Highly variable or Negative profits
- Negative cash flows
- Partial management team
- Additional risk of start-up

# The VC Method of Valuation

<b>Investment</b>	\$1 million
<b>Exit Year</b>	5th Year
<b>Revenues (5th year)</b>	\$20 million
<b>Net Profit (5th year)</b>	10% = \$2 million
<b>P/E (industry)</b>	12.5X
<b>Company Value</b>	\$25 million
<b>Required ROI</b>	40% = 5X
<b>Required Valuation</b>	\$5 million
<b>% of Company Required</b>	20%
<b>Pre-money Valuation</b>	\$4 million
<b>Post-money valuation</b>	\$5 million

# Valuations of VC Seed/Startup Rounds



Source: NVCA



# Benchmark Rates of Return

Risk-adjusted for stage of development:

<u>Stage of Business</u>	<u>ROI</u>	<u>5 yr X-factor</u>
Seed	60%	10x
Start-up	50%	8x
Early-stage	40%	5x
2 <sup>nd</sup> Stage	30%	4x
Near exit	25%	3x



# ROI and X Factors – How are they related?

ROI	Year 1	Year 2	Year 3	Year 4	Year 5	Factor
10%	110%	121%	133%	146%	161%	1.6 X
25%	125%	156%	195%	244%	305%	3.1 X
50%	150%	225%	338%	506%	759%	7.6 X
100%	200%	400%	800%	1600%	3200%	32.0 X

*[1 + rate of return]<sup>years to exit</sup>*

$$\text{Multiplier (X-factor)} = \frac{\text{[1 + rate of return]}^{\text{years to exit}}}{100}$$

$$\text{e.g. } 50\% \text{ ROI} = \frac{[1 + .5]^5}{100} = 7.6 X$$



# A Sample Early-Stage Portfolio

Invstmt	X Factor	5-yr ARR	Invstmt	X Factor	5-yr ARR
1	Zip	0 %			
2	Zip	0 %			
3	Zip	0 %			



# A Sample Early-Stage Portfolio

Invstmt	X Factor	5-yr ARR	Invstmt	X Factor	5-yr ARR
1	Zip	0 %	6	1.6	10 %
2	Zip	0 %	7	1.6	10 %
3	Zip	0 %			
4	1.3	5 %			
5	1.3	5 %			



# A Sample Early-Stage Portfolio

Invstmt	X Factor	5-yr ARR	Invstmt	X Factor	5-yr ARR
1	Zip	0 %	6	1.6	10 %
2	Zip	0 %	7	1.6	10 %
3	Zip	0 %	8	7.6	50 %
4	1.3	5 %			
5	1.3	5 %			



# A Sample Early-Stage Portfolio

Invstmt	X Factor	5-yr ARR	Invstmt	X Factor	5-yr ARR
1	Zip	0 %	6	1.6	10 %
2	Zip	0 %	7	1.6	10 %
3	Zip	0 %	8	7.6	50 %
4	1.3	5 %	9	20.0	82 %
5	1.3	5 %			



# A Sample Early-Stage Portfolio

Invstmt	X Factor	5-yr ARR	Invstmt	X Factor	5-yr ARR
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5	1.3	5 %	10	Life Support	

**Portfolio Return on Investments 1-9      ?? %**



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**Portfolio Return on Investments 1-9 3.7 X □ 26 %**

# VC Investor's Perspective

Investors aren't necessarily greedy ... they require a high rate of return to make up for their portfolio investments that don't hit it big

# VC Method in practice

- It helps to understand the numbers
- Potential investors will run the models to validate (but not to set) a valuation
- At the end of the day ... investors are
  - Looking for reasonable value
  - If they don't get the return, they won't go there
- Don't expect a lot of room for negotiation

# Pre- and post-investment

- Some variables shift with the investment
  - Total value of the company
  - Relative balance of ownership
- Example demonstrated

# Sample Capitalization (Cap) Table

Sample Capitalization Table					
<b>Pre Investment</b>					
<u>Unit Holders</u>	<u>Units Issued</u>	<u>Valuation</u>	<u>Pre Investment % Ownership</u>	<u>Post Investment % Ownership</u>	
John Doe	500,000	\$ 500,000	25%	19%	
Bill Smith	400,000	\$ 400,000	20%	15%	
Jane Brown	800,000	\$ 800,000	40%	31%	
ESO Pool	300,000	\$ 300,000	15%	15%	
<b>Total Issued:</b>	<b>2,000,000</b>	<b>\$ 2,000,000</b>	<b>100%</b>	<b>80%</b>	
<b>Post Investment</b>					
Investors	500,000	\$ 500,000	0%	20%	
<b>Total Issued:</b>	<b>2,500,000</b>	<b>\$ 2,500,000</b>		<u><b>100%</b></u>	

# The dreaded “Cram down”

Sample Capitalization Table					
Pre Investment					
<u>Unit Holders</u>	<u>Units Issued</u>	<u>Valuation</u>	<u>Pre Investment % Ownership</u>	<u>Post Investment % Ownership</u>	
John Doe	481,250	\$ 240,625	19.0%	11.5%	
Bill Smith	381,250	\$ 190,625	15.0%	9.5%	
Jane Brown	781,250	\$ 390,625	31.0%	19.0%	
Investors	481,250	\$ 240,625	20.0%	11.5%	
ESO Pool	375,000	\$ 187,500	15.0%	15.0%	
<b>Total Issued:</b>	<b>2,500,000</b>	<b>\$ 1,250,000</b>	<b>100.0%</b>	<b>62.5%</b>	
Post Investment					
Investors-Rd 2	1,500,000	\$ 2,000,000	0%	37.5%	
<b>Total Issued:</b>	<b>4,000,000</b>			<b>100%</b>	
\$750,000 raised at .50 per share or a decrease in valuation of 50%					

# What is the term sheet?

- Spells out expectations, obligations, relationships
- Addresses essential elements of agreement between investors and company
- Anticipate the *heartburn*: valuation, restricted stock provisions, vesting, liquidation preference, protective provisions, dilution, prep for Series B, C, etc.
- Samples in workbook

# What are tranches?

- Instead of receiving the entire money needed at once, some may be held back and disbursed upon hitting specified milestones (revenues, mgt team hire, product development, etc.)
- Still part of current round
- Pro – may instill added discipline and motivation
- Con – may reduce some management flexibility

# What does the VC investor expect ?

a “prepared” entrepreneur, which means:

- The entrepreneur has done their homework on making sure the investor/angel group/VC has interest in the field, product or service that the entrepreneur has developed.
- The entrepreneur can clearly convey the opportunity and the value proposition.

# A day in the life of an entrepreneur

