Talking to Investors

Learn How to Convey Your Message

Startup Management (IPIRI 63749B), Aleš Špetič, 2024

Learning Objectives

Understanding the Investment Dynamics

- Importance of Funding for Startups
- Overview of Key Topics:
    - Funding
    - Venture Capital
    - Process and Contacts
    - Presenting to Investors
    - Startup Deal Structure
    - Company Management
- Goal: Equip You with Insights for Successful Investor Conversations

Sources of Funding

Funding Options

	labour	debt	equity	subsidies
cost	health/family	interest	exit/dividend	taxes
benefit	freedom	no dilution	limited risk	free money
scalable	no	limited	yes	no

Types of Investors

Who Invests in Startups?

	strategic	long term	venture	4F
motive	partnership	dividend	exit	insanity
cost	innovation	growth	safety	social
benefit	market	hands off	potential	access

Venture Capital

Main Source of Funding for Startups

- Venture capital (VC) is funding provided to startups and small businesses with high growth potential.
- Typically involves equity stakes in the company.
- Key Players: Venture capital firms, angel investors, and institutional investors.

Stages of Venture Capital Funding

Phases of Capital Fundraising

- **Seed Stage**: Initial funding for developing an idea or prototype.
- **Early Stage**: Scaling operations and market entry.
- **Growth Stage**: Expansion into new markets or increasing production.
- **Late Stage**: Preparing for IPO or acquisition.

How Venture Capitalists Operate

Main Drivers of Capital Allocation

- **Funding Mechanism:** Provide capital in exchange for equity.
- **Risk Mitigation:** Diversify investments across multiple startups.
- **Support Role:** Offer mentorship, networking, and operational guidance.

Pros and Cons of Venture Capital

Main Drivers of Capital Allocation

Pros:

- Access to significant funding.
- Valuable mentorship and expertise.
- Strong networking opportunities.

Cons:

- Loss of equity and control.
- High expectations for growth and ROI.
- Pressure for quick exits.

What Venture Capitalists Look For

Investment Criteria

- **Scalable Business Model**: High growth potential.
- **Strong Founding Team**: Skills, experience, and vision.
- **Market Opportunity**: Large or growing market.
- **Unique Value Proposition**: Differentiation from competitors.
- **Financial Potential**: Clear path to profitability.

Venture Capital

Who is Who?

- **Limited Partners (LP)**: investors into the fund
- **General Partners**: people who make the investment decisions
- **Partners/Analysts/Associates**: the team who makes the ground work
- **Entrepreneur in Residence**: a friendly startup founder without a startup

Who is Who: Venture Capitalist

The Investors Powering Startups

Professionals or firms investing in startups in exchange for equity.

Specialize in different industries or stages of funding (e.g., Seed, Series A).

- **Roles**:
  - Provide financial backing.
  - Offer strategic guidance and mentorship.
  - Connect startups with their networks.

Who is Who: Limited Partners

The Funders of Venture Capital Firms

Entities that supply capital to venture capital funds.

- **Common LPs**:
    - Pension funds.
    - Endowments (non-profit funds)
    - High-net-worth individuals.
- **Role**:
    - Invest in VC firms expecting returns on their contributions.
    - Influence fund allocation indirectly.

Who is Who: General Partners

The Decision-Makers

Key operators within venture capital firms.

Manage the fund and make investment decisions.

Role:

- Identify startups with high growth potential.
- Negotiate deals and oversee portfolios.
- Responsible for delivering returns to LPs.

Who is Who: Entrepreneurs

The Visionaries Driving Startups

Founders or teams seeking venture capital to grow their businesses.

Roles:

- Develop and pitch business ideas.
- Execute growth strategies with VC support.
- Build the company while maintaining a partnership with investors.

Who is Who: Advisors

Guiding Growth and Decision-Making

External experts offering advice to both startups and VCs.

Roles:

- Help startups refine business strategies.
- Assist VCs in evaluating potential investments.
- Share industry-specific knowledge or connections.

Who is Who: Accelerators and Incubators

Nurturing Early-Stage Startups

Organizations providing early-stage funding, mentorship, and resources.

Examples: Y Combinator, Techstars.

Role:

- Prepare startups for future VC funding rounds.
- Offer seed investments and co-working spaces.

Who is Who: Angels vs. Venture Capitalists

How They Differ and Collaborate

Angel Investors:

- Invest personal funds in early-stage startups.
- Typically involved before VCs step in.

Venture Capitalists:

- Invest pooled funds from LPs.
- Target startups at various growth stages.

Venture Capital

Economics of a VC Fund

- LPs commit the funds, and pay in when needed. Sum of commitments is the **fund size**.
- LPs pay GPs for their service, e.g. 2% annually + 20% success fee (**carried interest**).
- **Lifespan of a fund**: they operate for a number of years (typically 10).
- During the time they need to invest, and recuperate their investment, so realistically their active **investment horizon** is 5 years.

Venture Capital

Investments size

- Startup: an investment should give **12-18 months** of runway
- VCs:
  - an investment should be **meaningful**
  - the size of a **ticket** should be reasonable for our size
  - we should divide the the risk by forming or joining a syndicate
- An investment is usually funding of the company for a 25-35% of shareholdings.

Economics of a VC Fund

Why do VC Chase Unicorns?

	I	II	III	IV	V	...	#	Exit
Failed	$3	$4	$5	$4	$3		19	0
Returns 1x	$1	$1	$2	$1	$2		7	$7
Successful 5x	0	0	$1	$2	0		3	$15
Unicorn 50x	0	0	$1	0	0		1	$50

A VC fund invested $30M in 5y, after disinvesting they had 19 failed investments, 7 that returned their money, 3 that returned 5X and 1 that returned 50x.

* for ilustration purposes, each investment = $1M

During the lifespan of the fund, it returned 2,4X of the investment amount. After deducting fees and carry, the fund returned less than 2X to investors.

Venture Capital

Exits / Liquidation events

Why are the businesses bought:

- **Financial**: discounted cash flow
- **Market**: share of the market
- **Technical**: technological advancement

- **IPO**: initial public offering

Venture Capital

Investment process

contact meetings due diligence

partner managing partners lawyers

pitch deck term sheet contract exit

dating mating engagement marriage

Presentation

How to Present Your Startup

- **Teaser**: A brief introduction to capture interest
- **Deck**: Comprehensive presentation covering key aspects
- **Business Plan**: Detailed documentation supporting the pitch

Presentation

What to Cover in Presentation

- **Team**: Background, skills, and roles
- **Product**: Features, distribution, technology
- **Market**: Size, defensibility
- **Business Model**: How are we making money?
- **Finance**: cash flow and financial needs
- **Competition**: Analysis and positioning

Choosing Investors

What to Expect?

- **Reputation**: Building a positive image
- **Network**: Leveraging connections
- **Experience**: Gaining insights and guidance
- **Money**: Financial support and investment capital

The Deal: Term Sheet

An Overview of Key Clauses

- The term sheet is a non-binding agreement outlining the terms and conditions of a startup investment.
- It is a foundation for legal agreements, such as shareholder agreements.

The funding

The Capital Injection

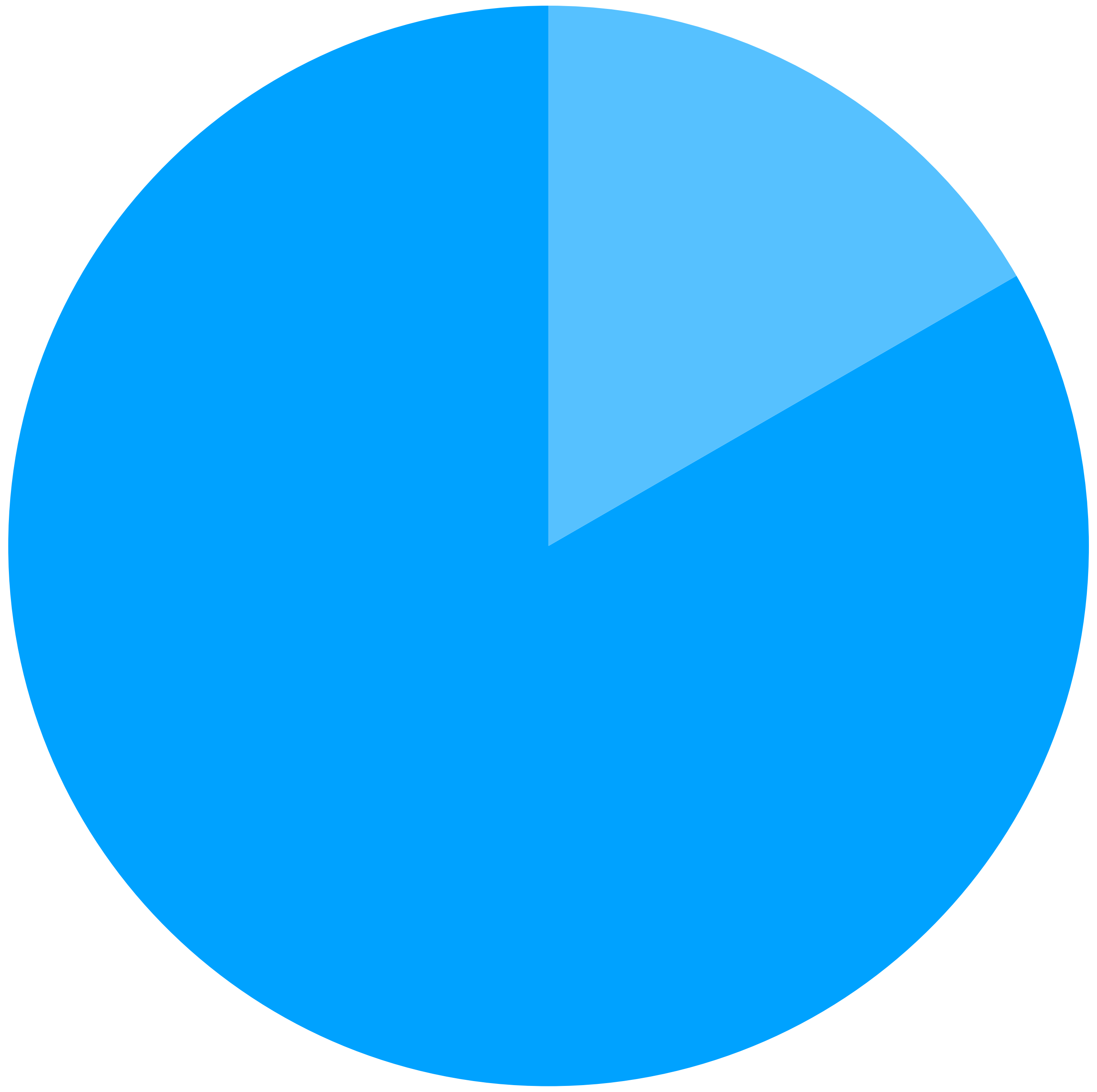
Investment Amount: The agreed amount the investor will contribute.

Equity Allocation: Details the percentage of ownership granted to the investor. It’s influenced by preexisting equity, option pools, and future dilution.

Valuation

Determining the Startup’s Worth

- **Pre-Money Valuation**: $10 million (83.3%)
- **Investment Amount**: $2 million (16.7%)
- **Post-Money Valuation**: The total, which equals $12 million.



Liquidation Preference

How proceeds from a sale are distributed.

Total Sale Proceeds: $20M

Investor's Initial Investment: $2M

Liquidation Preference: 1x ($2M back first).

Investor's Equity Stake: 20%.

Remaining Proceeds: Distributed among shareholders, including the investor.

Calculation:

- Investor gets $2M.
- Remaining Proceeds: $20M - $2M = $18M.
- Investor's Share of Remaining Proceeds: 20% of $18M = $3.6M.
- Founders/Other Shareholders: 80% of $18M = $14.4M.
- Total Payout for Investor: $2M + $3.6M = $5.6M.

Voting Rights

Influence in Decision-Making

Specifies the investor's voting power in company decisions.

Common Provisions:

- Protective provisions: Investor veto rights.
- Board seat allocation.

Anti Dilution Protection

Preserving Ownership Value

A clause that protects investors from dilution of their ownership when new shares are issued at a lower valuation than previous rounds (a “**down round**”)

Example:

- Post-Money Valuation: **$12M**.
- 1st investment: **$2M**
- 2nd investment (down): **$4M**
- Total Shares Outstanding: **1,200,000** (implying an initial share price of **$10/share**: $12M ÷ 1,200,000).
- Down Round ReValuation: $8M (implying a new share price of **$6.67/share**: $8M ÷ 1,200,000).

Anti Dilution Protection

Example:

	Investor Shares	Founders' Shares	Total
1st Round	200.000 (16.66%)	1.000.000 (83.33%)	1.200.000
Recalculation of shares for AD protection	300.300 ($2M/$6.67)	899.700	1.200.000
2nd Round (down)	600.000	0	
New allocation	50.01%	49.99%	

Founder Vesting

Commitment to the Company

Ensures founders earn equity over time.

Typical Terms:

- 4-year vesting with a 1-year cliff.
- Protects investors if founders leave early.

Option Pool

Incentivizing Employees and Supporting Startup Growth

An option pool is a percentage of a startup's equity set aside for employees, advisors, and others.

Provides stock options to incentivise and retain talent.

Encourages contributions to the company's growth.

An option: The right to buy a share within a period of time for a fixed price.

The Startup Deal

Simplified Capitalisation Table

		Angel	Seed	Series A	Series B	Comment
Peter	50%	45%	31,5%	18%	11,3%	Start of the company
Ana	50%	45%	31,5%	18%	11,3%	
Angels		10%	7%	4,0%	2,5%	First angels in
Seed			20%	20,0%	15,0%	Seed follows up in the Series A
VC group 1				25,0%	25,0%	First VC group follows up in the Series B.
VC group 2					20,0%	
Employees			10%	15,0%	15,0%	Employee equity is issued every round. (option pool)
Total	100%	100%	100%	100,0%	100,0%	
*in 1000s						
Investment		100	1.000	5.000	30.000	
Valuation		1.000	5.000	20.000	150.000	
Founders		450	1.575	3.600	16.875	

The Board in a Startup

Guiding Growth and Strategic Decisions

The board of directors is a group responsible for overseeing the company's strategy, governance, and financial performance.

Founders: Often retain seats as the company's visionaries.

Investors: Typically secure seats after providing significant funding.

Independent Members: Experts or industry veterans who bring unbiased perspectives.

Key Responsibilities:

- Set strategic direction and approve major decisions.
- Monitor the company's financial health and ensure legal compliance.
- Support the CEO and leadership team with mentorship and advice.

Company Management

Governance Structure

- **Executive Directors**: Involved in day-to-day operations and decision-making.
- **Non-executive Directors:** Provide external perspectives and strategic insights.
- **Voting Rights**: Execs and Non-Execs participate in board decisions, voting power could be non-linear.
- **Signing Rights**: Determines who can sign legal agreements on behalf of the company. Typically held by the CEO or designated executives.

Conclusion

Talking to Investors

- Understanding the roles and dynamics of investors
- Investment essentials, grasping the complexities of VC invesments
- Navigating the funding rounds
- Company governance