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An Introduction to Venture Capital

GraniteVentures LLC

Granite representatives

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Introduction to Granite Ventures

- **Founded in 1992**
- **Granite has 9 investment professionals**
- **Over $1B under management**
  - Recently raised a new $350M fund
- **Early-stage technology focus**
- **Hands-on investors**
- **Excellent long-term results**

Intro to venture capital

1) Options for financing a startup

2) How does the venture industry work

3) Launching a startup

4) The investment process

Options for financing a startup
Internal

- **Your personal savings**
- **Internal cash flow**

- **You retain control**
- **You receive 100% of the upside, but bear all the risk of failure**
- **Limited by available savings/cash flow**
- **You don’t know everything….might not seek external support**
- **Difficult to do for some technologies/business models**

Options for financing a startup
External debt

- **Debt financing can include:**
  - Credit cards
  - Loans from family members
  - Bank loans

- **Lenders don’t own any of the company**
- **Lenders receive a fixed rate of return**
  - Loan amount or “principal” must be paid back
  - Claim on the company’s (or personal) assets in event of default
- **Limited by lack of assets**
- **Lenders are typically passive investors**

- **Convertible venture debt**

Options for financing a startup
External equity

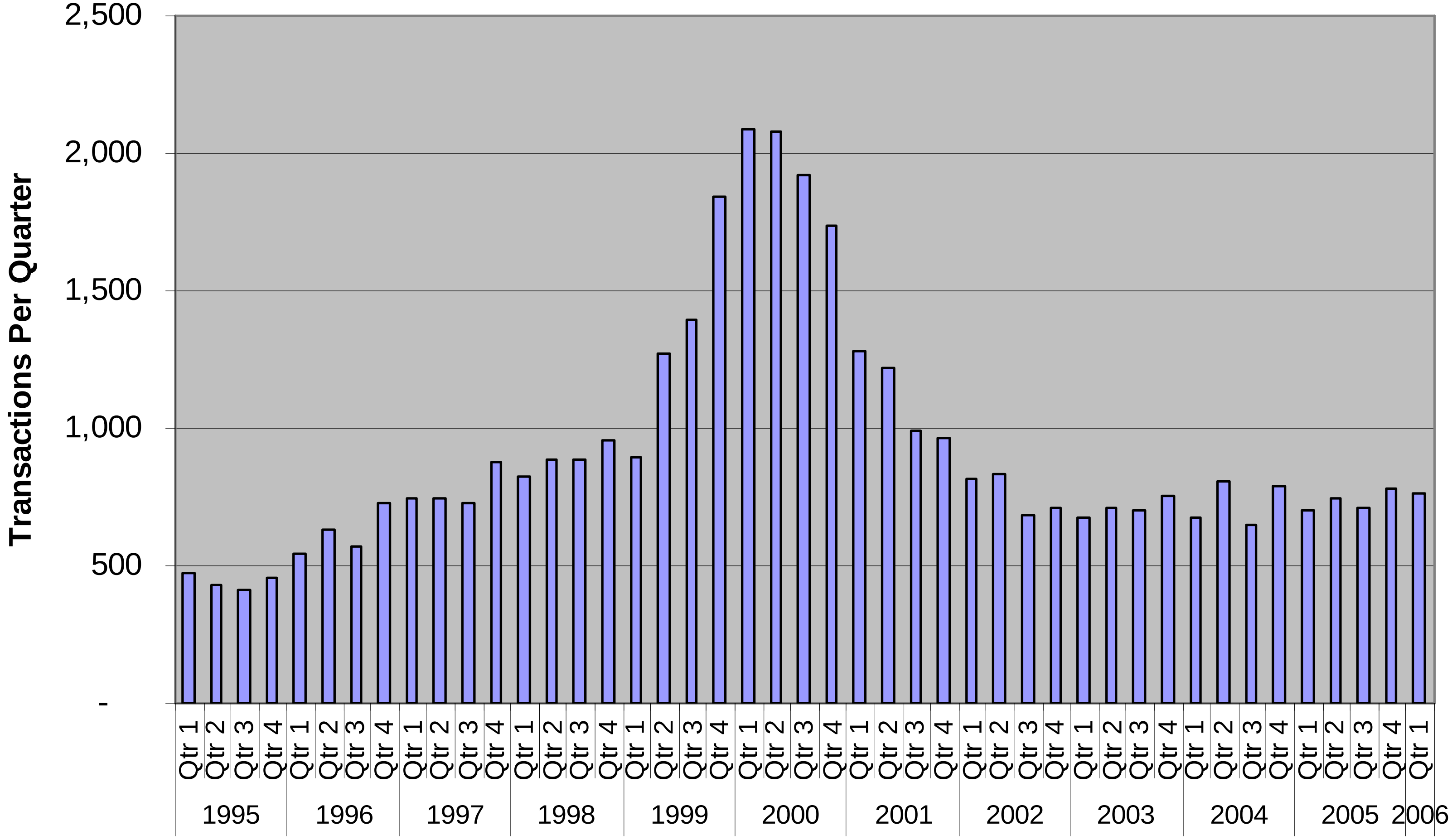
- **Equity is ownership exchanged for money**
- **Equity sources can include:**
  - You
  - Friends and family
  - Wealthy individuals (Angels)
  - Venture capital firms

- **Share the upside and the risk**
- **Flexible**
- **Doesn't need to be paid back**
- **Illiquid**
- **Share or cede control**

Why use venture capital?

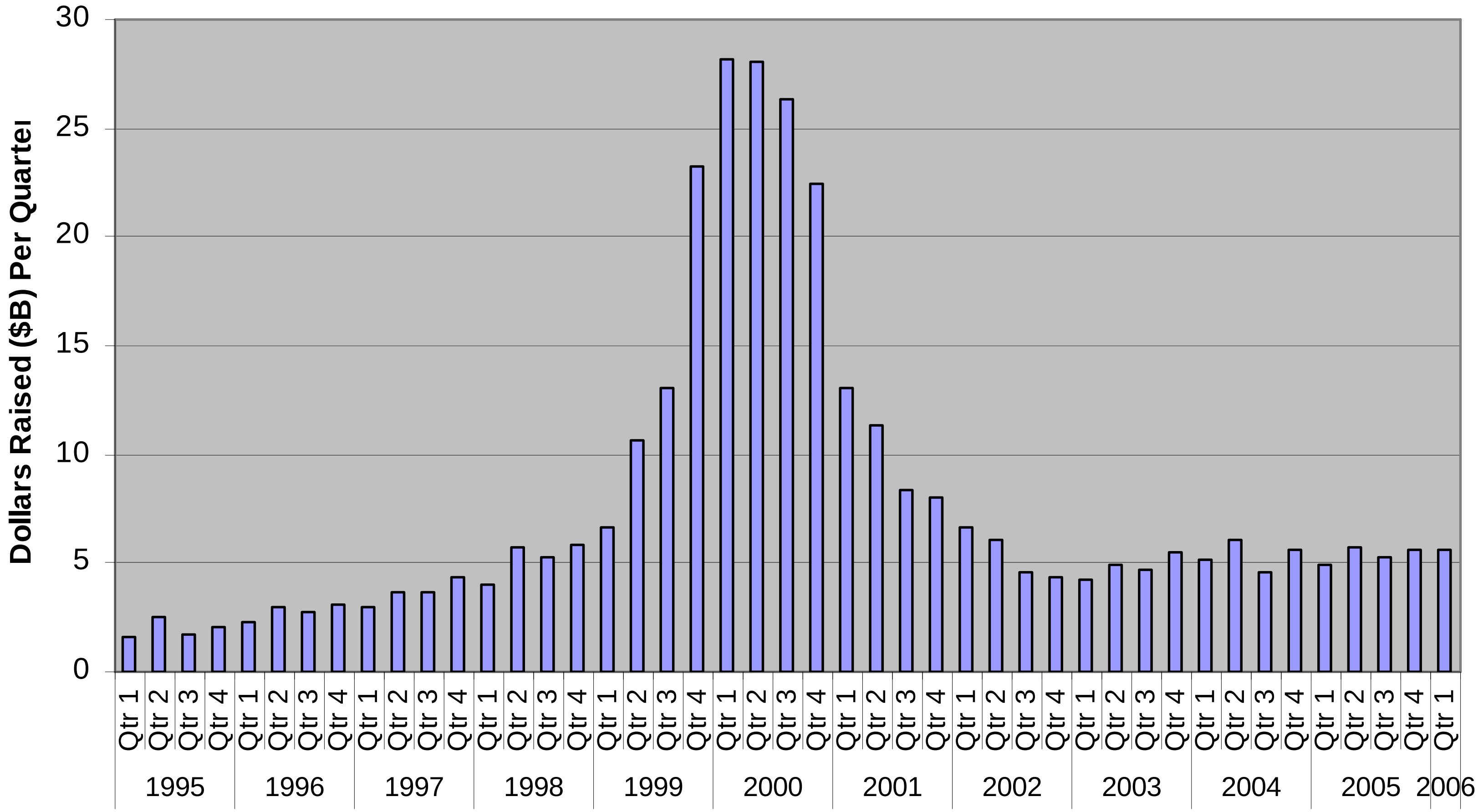
- **Provide large amounts of capital**
  - Average start-up consumes 10's of millions of dollars
- **Provide advice**
  - Extensive experience in building start-ups
- **Offer introductions and relationships**
  - Potential customers
  - Partners
  - Other investors
  - Acquirers
  - Management talent
- **Reputation value to customers, employees, and partners**
  - Access to additional capital
  - Rigorous and independent evaluation of business prospects

National venture transactions



Source: NVCA

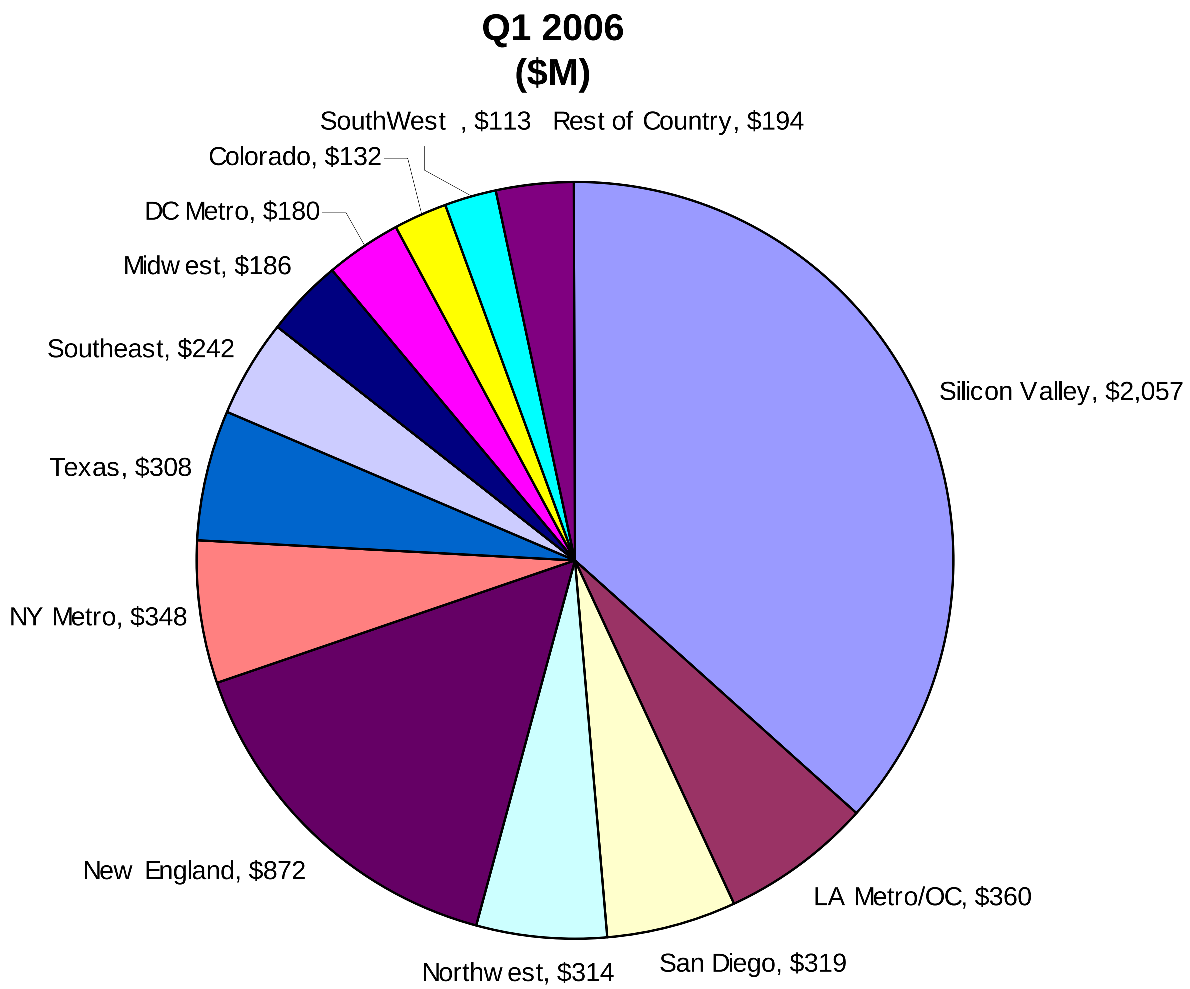
National venture dollars raised



Source: NVCA

GraniteVentures LLC

Geographic breakdown of venture capital

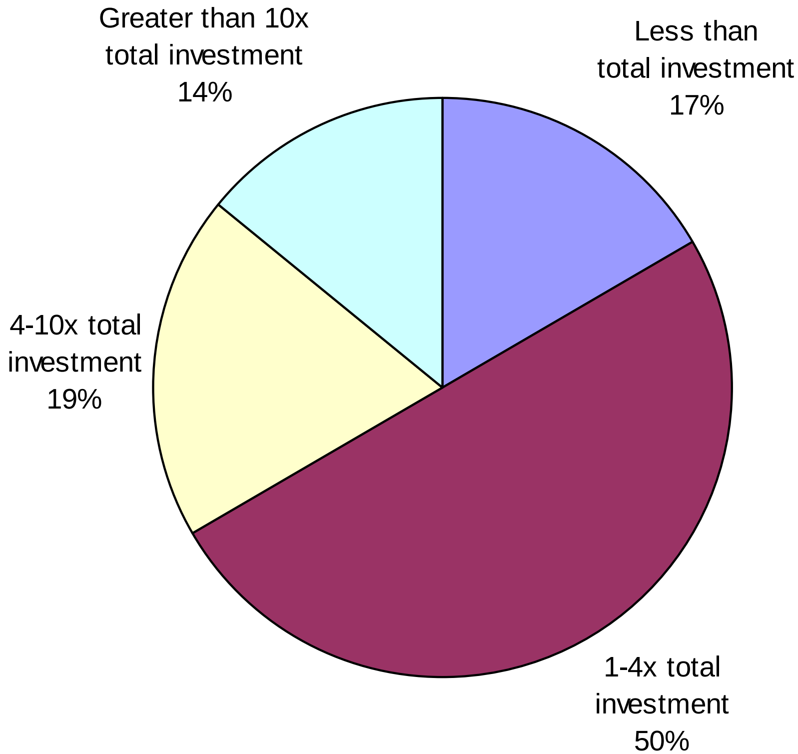


Source: NVCA

How do VCs make money?

- **VCs raise money from their own investors or “limited partners”**
  - Pension funds, university endowments, wealthy individuals, etc.
- **VCs to invest this money in a set of companies (the “portfolio”)**
  - Stage
  - Risk profile
  - Sector
  - Length of time to realize return or “liquidity”
- **VCs realize a profit when their ownership is sold.**
  - Acquisition by a larger company
    - Example: Purchase of Skype by Ebay in Sept. 2005
  - Initial public offering (IPO) on a stock exchange
    - Example: Google’s in Aug. 2004
- **The success of a venture capital company depends on the success of its portfolio companies**

Q1 2006 venture M&A Outcomes



Source: Thompson Venture Economics and the NVCA

Where do technology startups come from?

- **Academia**
  - Yahoo and Google were started by Stanford graduate students
  - Broadcom was started by an UCLA professor and graduate student
- **Teams from established companies**
  - Intel was started by a group of engineers from Fairchild Semiconductor
  - Siebel was started after Tom Siebel left Oracle and then Sybase
- **Spin outs from established companies**
- **Government labs**
- **Individual entrepreneurs**
  - Oracle
  - Dell

The investment funnel

SOURCE → EVALUATE → INVEST

Source
- Personal Networks
- Affiliated Entrepreneurs
- Company Management
- University & Corp. Relationships
- Venture Community

Initial Analysis
- 1600+ deals per year

Due Diligence
- 50 deals per year
- Multiple team meetings
- Validate product/market match
- In-depth referencing

Investment
- 5-10 deals per year
- Active involvement
- Drive value creation
- Maximize exit value

What we look for in start-ups

Market
- Growing
- Changing
- Undefined

Team
- Great entrepreneurs
- Leaders in their field
- Add complementary skills

Product
- Proprietary technology
- Sustainable advantage
- Follow-on products

Competition
- Be a leader in a new space
- No frontal assaults on industry leaders
- Avoid start-up clutter

Financial
- Capital efficient
- Scalable business model
- Flexible infrastructure

Terms
- Attractive valuation
- Clean structure
- Strong co-investors

Deciding to launch a start-up

Market

- Growing
- Changing
- Undefined

- Network with customers and with the leaders of the market
- Build market models from top-down and bottom-up
- Become an expert in your marketplace

Deciding to launch a start-up

Market

- Growing
- Changing
- Undefined

Team

- Great entrepreneurs
- Leaders in their field
- Add complementary skills

- Demonstrate your ability to make progress through your creativity and tenacity
- Network with and affiliate leaders in the industry
- Recruit people who complement your skillset, experience
- Recruit people with a track record of success

Deciding to launch a start-up

Market

- Growing
- Changing
- Undefined

Team

- Great entrepreneurs
- Leaders in their field
- Add complementary skills

Product

- Proprietary technology
- Sustainable advantage
- Follow-on products

- Prove out the unique aspects of your technology
- Make sure you handle your IP properly
- Explore your roadmap for extending your product line and competitive advantage

Deciding to launch a start-up

Competition

- Be a leader in a new space
- No frontal assaults on industry leaders
- Avoid start-up clutter

- Study the competition
- Understand the industry dynamics and how they relate to your opportunity
- Remember that competitors will not stand still

Deciding to launch a start-up

Competition

- Be a leader in a new space
- No frontal assaults on industry leaders
- Avoid start-up clutter

Financial

- Capital efficient
- Scalable business model
- Flexible infrastructure

- Build a detailed financial model for your business
- Spend as little money as possible
- Avoid long-term commitments

Deciding to launch a start-up

Competition

- Be a leader in a new space
- No frontal assaults on industry leaders
- Avoid start-up clutter

Financial

- Capital efficient
- Scalable business model
- Flexible infrastructure

Terms

- Attractive valuation
- Clean structure
- Strong co-investors

- Set out with reasonable expectations
- Don’t entangle business with personal relationships
- Don’t entangle business with non-standard structures
- Investor reputation counts

What to look for in a VC (besides $)

- Strong track record
- Good reputation
- Good cultural match for your team & approach
- Active and engaged enough to provide value
- Mature enough to avoid micromanagement
- Relevant experience (sector, technology, customer base, etc.) and networks
- Complementary portfolio of companies

The investment process

- **Create and refine a pitch**
- **Get lots of advice and feedback….refine**
- **Be prepared for detailed diligence**
  - Market models
  - Technical papers and analysis
  - Financials
  - Customer feedback
- **Partner meeting**
- **Term sheet**
- **Legal work to close deal**

Some key terms: term sheet

- **A term sheet lists the main terms and conditions associated with a potential investment**
  - Valuation
  - Rights and preferences of Preferred Stockholders
  - Board representation
  - Control provisions
- **The first term sheet is the hardest to obtain**
  - Sometimes a "no-shop" will be incorporated
- **Term sheets are non-binding and serve to finalize negotiations**

Some key terms: shares of stock

- **Ownership in a company is measured in shares of stock**
  - The absolute number of shares is less important than the percentage
- **Not all types or "classes" of stock are created equal**
  - Common shares are held by company founders, employees, etc.
  - Preferred shares are held by investors and posses special rights
    - Liquidation preferences (first to get money back)
    - Voting agreements (require consent for certain company transactions)
    - Board seat rights
    - These rights and preferences allow the VC to protect its investment.
  - There can be various versions or "series" of preferred shares (Series A, Series B, etc.) that differ in purchase date, price, and rights
- **In the case of an IPO (or in some very lucrative acquisitions) all classes of stock convert to common shares**

Some key terms: stock options

- **Stock options are rights to purchase stock in the future at fixed price determined when the option is “issued” or granted**
- **Options motivate employees to add value to the company by enabling them to share in success**
  - Options help align the interests of employees with founders and investors
- **Granted options usually “vest”, or become available for use, according to a schedule**
  - Options often vest over four years
- **Just like with stock shares the number of options is less important than the percentage**

Some key terms: valuation

- **Pre-money valuation: the value of the company prior to an investment**
- **Post-money valuation: the value of the company after the investment**
- **It is important to have an appropriate valuation for the company**
  - The lower the valuation, the more ownership you give up
  - The higher the valuation, the more difficult it is to raise money
- **The company's valuation should be evaluated with its long term capital requirements**

Example of valuation and dilution

	%	Value $M
Founder's Pre-Money Ownership %	100%	**?**

Series A Pre-Money Valuation		$5
Series A Investment		$5
Series A Post-Money Valuation		$10
Series A Investor Ownership	50%	$5
Founder's Post-Money Ownership	50%	$5

Example of valuation and dilution (cont.)

	%	Value $M
Founder's Pre-Money Ownership %	100%	?

Series A Pre-Money Valuation		$5
Series A Investment		$5
Series A Post-Money Valuation		$10
Series A Investor Ownership	50%	$5
Founder's Post-Money Ownership	50%	$5

Series B Pre-Money Valuation		$20
Series B Investment		$5
Series B Post-Money Valuation		$25
Series A Investor Ownership %	40%	$10
Series B Investor Ownership %	20%	$5
Founder's Post-Money Ownership%	40%	$10
Total	100%	$25

Some key terms: Board of Directors

- **The Board of Directors governs the company and often includes representatives of founders, management, and investors**
  - May also include an independent Board member from industry
- **After a raising venture capital, you will probably be a minority on the Board**
  - Increases the importance of trust and relationship with investors
- **The Board typically meets monthly or quarterly**
  - Reviews progress
  - Makes important decisions
- **The Board stewards the company and is legally responsible**

Sample term sheet

The Company

MEMORANDUM OF TERMS FOR PRIVATE PLACEMENT OF EQUITY SECURITIES

Granite Ventures and third parties to be identified (the “Investors”) are prepared to million in The Company, Inc. (the "Company") under the terms contained in this term she term sheet is a non-binding document prepared for discussion purposes only, and the prop investment is specifically subject to customary stock purchase agreements, legal due dilig other conditions precedent contained herein, all satisfactory to the Investors in their sole d

New Securities Offered:	7,000,000 shares of Series A Preferred (the "Preferre		
Aggregate Purchase Price:	$7,000,000		
Purchase Price Per Share:	$1.00 per share of Preferred (implied pre-money, ful valuation of $5.0 million)		
Post-Financing Capitalization:	Common Stock -		
	Founders	3,200,000	26.7%
	Stock Option Program	1,800,000	15.0%
	Preferred Stock -		
	Investors	7,000,000	58.3%
	Total Common Equivalent		100.0

Rights, Preferences and Privileges of Preferred:

(1) Dividends: 8% non-cumulative dividend per an preference to any dividend on the Common, wh declared by the Board. The Preferred shall also participate pro rata (on a Common equivalent ba any dividends paid on the Common.

(2) Liquidation Preference: Upon a liquidation of the Company, the Preferred will receive the Purchase Price Per Share plus any declared and unpaid dividends. Remaining assets distributed pro-rata on an as-converted basis among the Preferred and Common. A consolidation, merger or other transaction where the shareholders of the Company do not continue to hold at least a majority interest in the Company or successor entity, or a sale of all or substantially all of the

- **Non-binding**
- **Valuation is stated on a per share and total basis**
- **Capitalization illustrates impact on ownership**
- **Key rights and terms are spelled out**

Sample term sheet (cont.)

Board Composition and Meetings:

The Company's by-laws will provide for 5 Directors
close of this financing, the Company's Board of Dire
consist of:

Two Preferred representatives
Two Common Representative
One Outside director

So long as at least 50% of the Preferred issued in thi
financing remains outstanding, holders of the Preferr
as a class will elect two (2) Directors, and holders of
Common voting as a class will elect one (2) Director
other Directors will be elected by a majority of the C
and Preferred, voting as separate classes. The Invest
be granted observation rights for one observer with r
all Board meetings. It is the intention of the Founde
Investors to work together following the closing of t
financing to appoint a non-employee director to the
The Holders of the Preferred will enter into a Voting
Agreement regarding the selection of the 2 board
representatives of the Preferred.

Special Board Approval Items:

Board approval will be required for:

1. Hiring of all officers of the Company.
2. Any employment agreements (approval by a ma
outside (non-employee) Directors, or a Compen
Committee consisting of outside (non-employee
Directors when established).
3. Compensation programs including base salaries a
programs for all officers and key employees (app
a majority of outside (non-employee) Directors,
Compensation Committee consisting of outside (
employee) Directors when established).
4. All stock programs as well as issuance of all sto
options or warrants (approval by a majority of o
(non-employee) Directors, or a Compensation C
consisting of outside (non-employee) Directors
established).
5. Annual budgets, business and financial plans.
6. All real estate leases or purchases.
7. Entrance into all obligations or commitments, in
capital equipment leases or purchases, with total
greater than $10,000 and which are outside the r
recent business plan or budget approved by the
Directors.

- Term sheet specifies break down of Board of Directors
- Term sheet spells out control items which require approval of the Board

Conclusions

- Carefully weigh your financing options
- Venture capital equity good fit for startups
- Venture market is large and active
- Established approach and pattern for launching a startup from academia
- Focus, engage, learn, iterate

Thank you!

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