An Introduction to Venture Capital
Granite representatives

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- Brian Panoff – Vice President
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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
Geographic breakdown of venture capital

Q1 2006 ($M)

Silicon Valley, $2,057
LA Metro/OC, $360
San Diego, $319
Northwest, $314
New England, $872
NY Metro, $348
Texas, $308
Southeast, $242
Midwest, $186
DC Metro, $180
Colorado, $132
Southwest, $113
Rest of Country, $194

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

- Greater than 10x total investment: 14%
- Less than total investment: 17%
- 4-10x total investment: 19%
- 1-4x total investment: 50%

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**

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

**EVALUATE**

**Initial Analysis**
- 1600+ deals per year

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

**INVEST**

**Investment**
- 5-10 deals per year
- Active involvement
- Drive value creation
- Maximize exit value
## What we look for in start-ups

<table>
<thead>
<tr>
<th><strong>Market</strong></th>
<th><strong>Team</strong></th>
<th><strong>Product</strong></th>
<th><strong>Competition</strong></th>
<th><strong>Financial</strong></th>
<th><strong>Terms</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>- Growing</td>
<td>- Great entrepreneurs</td>
<td>- Proprietary technology</td>
<td>- Be a leader in a new space</td>
<td>- Capital efficient</td>
<td>- Attractive valuation</td>
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<td>- Changing</td>
<td>- Leaders in their field</td>
<td>- Sustainable advantage</td>
<td>- No frontal assaults on industry leaders</td>
<td>- Scalable business model</td>
<td>- Clean structure</td>
</tr>
<tr>
<td>- Undefined</td>
<td>- Add complementary skills</td>
<td>- Follow-on products</td>
<td>- Avoid start-up clutter</td>
<td>- Flexible infrastructure</td>
<td>- Strong co-investors</td>
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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 possess 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

<table>
<thead>
<tr>
<th>%</th>
<th>Value $M</th>
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<tr>
<td>Founder's Pre-Money Ownership %</td>
<td>100%</td>
</tr>
<tr>
<td>Series A Pre-Money Valuation</td>
<td>$5</td>
</tr>
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</tr>
<tr>
<td>Series A Post-Money Valuation</td>
<td>$10</td>
</tr>
<tr>
<td>Series A Investor Ownership</td>
<td>50%</td>
</tr>
<tr>
<td>Founder's Post-Money Ownership</td>
<td>50%</td>
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Example of valuation and dilution (cont.)

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<th>%</th>
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<td>Series B Pre-Money Valuation</td>
<td>$20</td>
</tr>
<tr>
<td>Series B Investment</td>
<td>$5</td>
</tr>
<tr>
<td>Series B Post-Money Valuation</td>
<td>$25</td>
</tr>
<tr>
<td>Series A Investor Ownership %</td>
<td>40%</td>
</tr>
<tr>
<td>Series B Investor Ownership %</td>
<td>20%</td>
</tr>
<tr>
<td>Founder's Post-Money Ownership %</td>
<td>40%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
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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

MEMORANDUM OF TERMS FOR PRIVATE PLACEMENT OF EQUITY SECURITIES

Granite Ventures and third parties to be identified (the “Investors”) are prepared to invest $7,000,000 in The Company, Inc. (the “Company”) under the terms contained in this term sheet is a non-binding document prepared for discussion purposes only, and the proposed investment is specifically subject to customary stock purchase agreements, legal due diligence, and other conditions precedent contained herein, all satisfactory to the Investors in their sole discretion.

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

Rights, Preferences and Privileges of Preferred:
1. Dividends: 8% non-cumulative dividend per annum, declared by the Board. The Preferred shall also participate pro rata (on a Common equivalent basis) 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...
### Board Composition and Meetings:

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

- Two Preferred representatives
- Two Common Representatives
- One Outside director

So long as at least 50% of the Preferred issued in this financing remains outstanding, holders of the Preferred 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 Common and Preferred, voting as separate classes. The Investors are granted observation rights for one observer with all Board meetings. It is the intention of the Investors to work together following the closing of this financing to appoint a non-employee director to the Board. 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 majority of outside (non-employee) Directors, or a Compensation Committee consisting of outside (non-employee) Directors when established).
3. Compensation programs including base salaries: programs for all officers and key employees (approval by a majority of outside (non-employee) Directors, or a Compensation Committee consisting of outside (non-employee) Directors when established).
4. All stock programs as well as issuance of all stock options or warrants (approval by a majority of outside (non-employee) Directors, or a Compensation Committee consisting of outside (non-employee) Directors when 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 recent business plan or budget approved by the Board.

- **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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