

The Role of the Board in Startup Fundraising

March 10, 2021



ANGEL CAPITAL ASSOCIATION



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WHAT TODAY IS... AND ISN'T ABOUT

- ✓ The Board's role in managing a funding round
- ✗ Not how to fundraise successfully
- ✗ Nor how to magically find funding for under-performers



FUNDRAISING AND THE BOARD: AGENDA

- **When?** (do we Fundraise)
- **Who?** (fundraises)
- **With Whom do we negotiate?** (what next round Investor)
- **What?** (Terms and Valuation)
- **How?** (To Avoid Conflict and Litigation)

And

Wise guys

Tango!

Uppers and Downers

Liars, Thieves and Clowns

Arms Treaties

THE MOST IMPORTANT RESPONSIBILITIES OF THE BOARD

- Hire and fire the CEO
- Sell the company
- Never run out of money
 - John Huston, Ohio Tech Angels

WHEN DO WE FUNDRAISE?

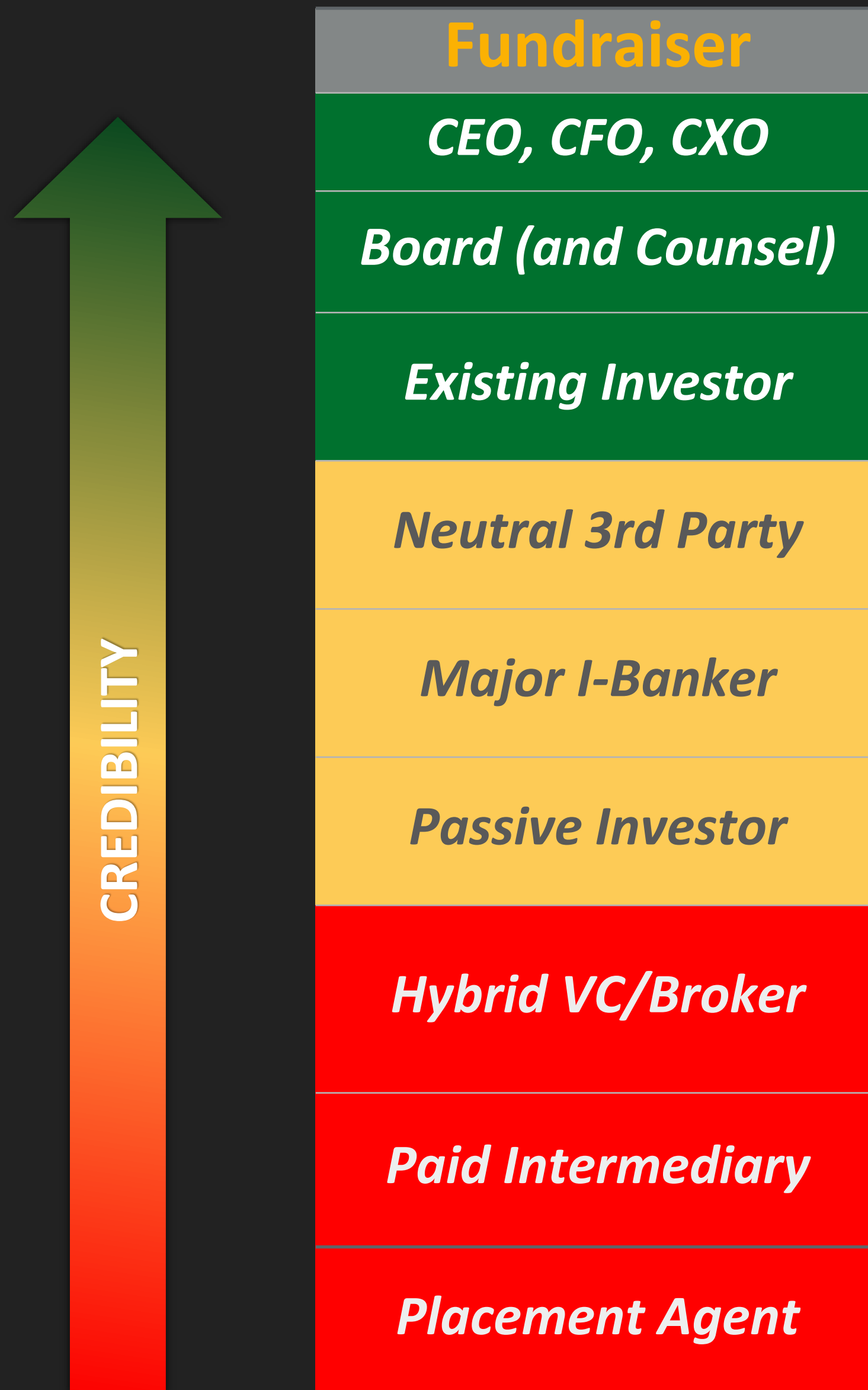
Answer:

All the time.


But, at a minimum, six months before the end of our cash runway.

Even Apple fundraises all the time.

WHO SHOULD FUNDRAISE FOR EARLY-STAGE COMPANIES?



WHO SHOULD FUNDRAISE FOR EARLY-STAGE COMPANIES?



Fundraiser	Rationale	Reactions
CEO, CFO, CXO	A core responsibility	CEO fundraising is essential
Board (and Counsel)	A core responsibility	Trusted participants
Existing Investor	Introductions are part of value-add	...especially if investing in this round
Neutral 3rd Party	Friendly introduction	Can't hurt
Major I-Banker	Part of value add role	Can be helpful but expensive
Passive Investor	Helpful... but...	failure to re-invest (except if an old fund) is a negative
Hybrid VC/Broker	Invests in Series A as a come-on for follow-on fundraising brokerage	May take as much as 30% of capital as fee. Fees are a terrible use of capital raised
Paid Intermediary	CEO is busy, has no fundraising skills or company is foreign	Credible only if intermediary invests, too. (In an infinity of worlds, it could happen.)
Placement Agent	CEO too busy or inexperienced	"You're being paid to fundraise. Why should I believe <i>anything</i> you say?"

HELLO, BOARD! FUNDING IS YOUR RESPONSIBILITY

- The Board monitors cash flow
- The Board participates in and catalyzes the round
- The Board approves investor targets and proactively opens doors
- The Board, not the CEO, manages fundraising
- The CEO handles things day-to-day but is monitored by the Board
- The Board tracks all activity, targets, conversations
- The Board approves all investor presentations & financials
- The Board negotiates, reviews and authorizes the company to accept the term sheet
- The Board monitors “getting to close”

WHO: MANAGING THE PROCESS

- CEO is on the front line, meeting with investors
- Board may need to meet weekly or more frequently
- Role of special Fundraising Committee / Executive Committee
- Role of Independent Director(s)

WHOM DO WE NEGOTIATE WITH? NEXT ROUND INVESTORS

Financing	What's Important
Angel Syndication	Shared, trusted diligence; trusted Board member
Strategics	Access to innovation & new business models
VCs	5x to 10x returns, effective control
Venture Debt / Banks	Risk-free (to lender) financing

FOLLOW-ON INVESTORS MAY NOT BE ALIGNED WITH

	Company Deal Strategy	VC Strategy	Angel Strategy
Valuation	As high as possible	Low enough to make money and entice later investors	Low at Angel round, steady increase at later rounds
Liquidation Preferences	Not if we can help it! Management may demand an exit carveout if preferences smother common	A primary downside protection	Don't set a precedent enabling a large preference stack
Future Financing	Yes! We need to survive and scale	Yes: we need to deploy capital and back our winners	Be a a capital efficient company so that future capital needs are modest and only mildly dilutive
Participate in Future Financing?	We will ask for an option refresh to counter dilution at each round	Yes, and we're not averse to recapping (and crushing Angels)	Possibly... until our pro-rata becomes unaffordable or unavailable. Weak anti-dilution protection
Returns Goal	Make our 20% equity pool worth a fortune	3x-20x+ depending on whether early or late stage VC	10x to 30x+ reward for earliest risk
Exits	We're going for the gold—would love an IPO (which also eliminates those pesky preferences) ^[1] . Will accept a high value M&A	Early investor: either M&A or IPO is fine Later investor: we'd better get a nice multiple of our Series C, D, E... price	Near term exits are safer. ^[1] Longer term exits have more upside but more risk of dilution or cram down along the way

WHAT: FUNDRAISING ISN'T JUST ABOUT CHECK SIZE & VALUATION

- Naive Boards/CEOs ask, “How much will you invest and what’s the valuation you’ll give us?”
- Experienced CEOs and Boards ask, “What’s the deal?”
 - Next round investors ask, “Is my reward worth the risks?”
 - Risks are mitigated by valuation & by other terms in the term sheet.
 - Unless you understand how follow-on investors view the risks and rewards of your company, you won’t effectively negotiate your financing round.

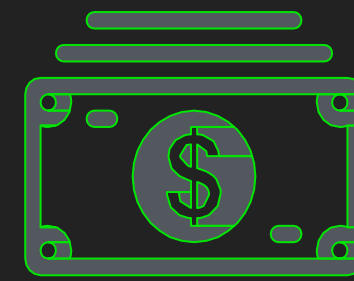
FINANCING ROUNDS: POINTS TO REMEMBER

- Financing is part of a broader discussion about the investor / company relationship and long-term risks and rewards.
- That relationship is outlined in a term sheet, defining the investment round.
- An optically high valuation can be offset by key deal terms:
 - stronger governance, liquidation preferences, mandatory redemption, accumulating dividends, warrants, penalties for missing sales targets. Ridiculous unicorn valuations are often privately “offset” in this way.
- The more capital you raise, the more rounds you will negotiate. Every capital raise presents new control and valuation risks.

Potential Risk Mitigating Terms

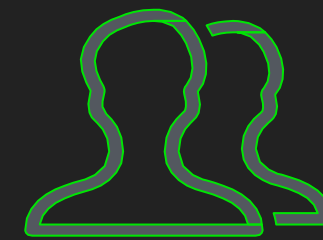
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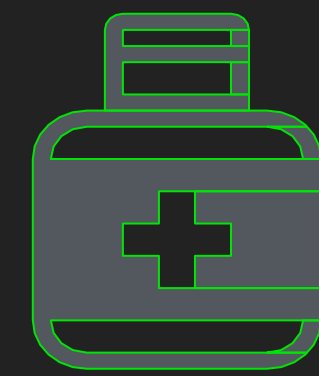
Deal Economics

- Size of round
- Pre-or Post-money valuation
- Liquidation preference
- Option pool
- Dividends



Management & Control

- Board seats & control
- Information rights
- Founder vesting, IP assignment, non-compete and more



Investor Rights

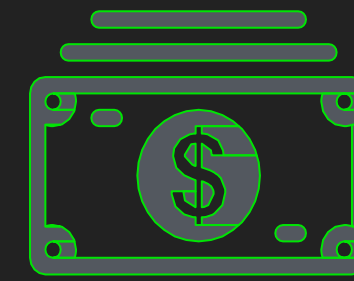
- Approval rights
- Participation rights
- Anti-dilution
- ROFR & co-sale rights



Exits & Liquidity

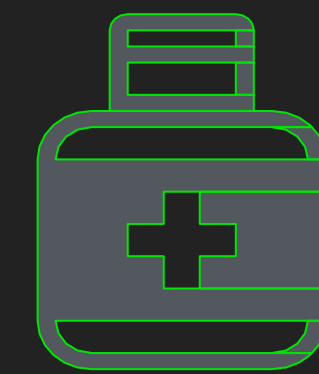
- Rights to block founder transfers
- Drag-along rights
- Redemption rights
- Registration rights

Extreme Case: Post-Money SAFE Lacks Any Risk Mitigation Terms



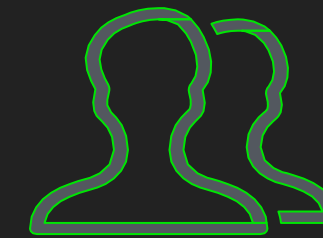
Deal Economics

- ~~Size of round~~
- **Post-money valuation**
- **Liquidation preference**
- ~~Option pool~~
- ~~Dividends~~



Investor Rights

- ~~Approval rights~~
- ~~Participation rights~~
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- ~~ROFR & co-sale rights~~



Management & Control

- ~~Board seats & control~~
- ~~Information rights~~
- ~~Founder vesting, IP assignment, non-compete and more~~



Exits & Liquidity

- ~~Rights to block founder transfers~~
- ~~Drag-along rights~~
- ~~Redemption rights~~
- ~~Registration rights~~

“ONE AND DONE?” NO. EXPECT TO RAISE MULTIPLE ROUNDS PRIOR

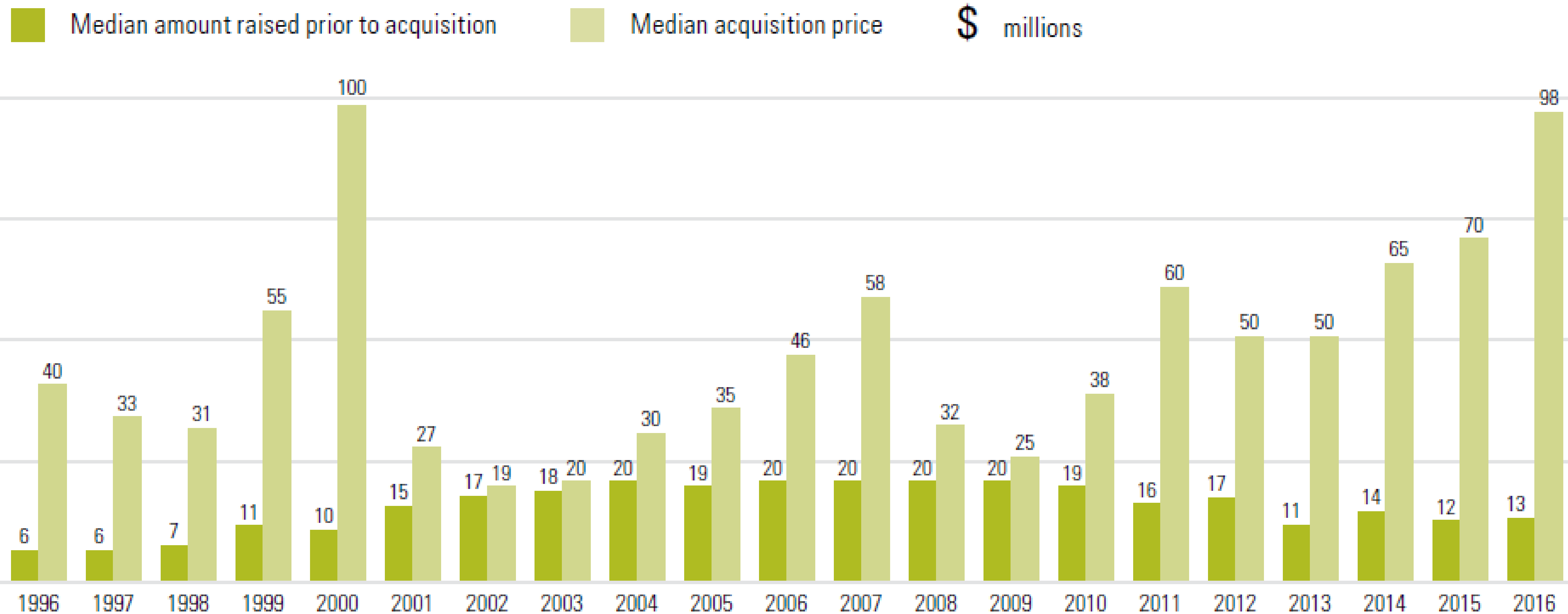
	<i>Median Multiple of Invested Capital (MOIC)</i>	<i>Average Return MOIC</i>	<i>Median M&A Realized</i>	<i>Median Equity Invested</i>	<i>Average Equity Invested</i>	<i>Average # Funding Rounds</i>
<i>Telecom, Messaging</i>	2.5	4.1	\$87,660,000	\$21,830,000	\$ 22,324,999	2.6
<i>Energy/Cleantech</i>	5.8	6.2	\$343,400,000	\$42,250,000	\$ 58,002,194	4.2
<i>B2C SW</i>	5.9	5.9	\$146,445,000	\$18,000,000	\$ 55,170,426	3.1
<i>Fintech software</i>	6.4	6.6	\$105,465,000	\$15,290,000	\$ 34,582,222	2.4
<i>Consumer software</i>	6.5	7.9	\$119,544,510	\$10,500,000	\$ 22,787,761	4.1
<i>Medical Device</i>	6.9	11.0	\$150,942,857	\$31,518,531	\$ 34,687,912	4.1
<i>Biotech</i>	7.2	9.4	\$429,051,724	\$48,400,002	\$ 58,919,981	3.5
<i>Security software</i>	7.4	8.9	\$122,291,667	\$11,524,995	\$ 20,007,199	2.6
<i>Media Infrastructure</i>	7.4	7.4	\$137,600,000	\$26,140,000	\$ 19,968,134	3.2
<i>Marketing / Advertising / Customer Analytics</i>	8.1	20.9	\$161,049,429	\$7,000,000	\$ 15,235,600	3.0
<i>Dev Tools / UI / Platform</i>	9.1	11.2	\$102,130,769	\$9,000,000	\$ 10,930,769	2.7
<i>Cloud / Internet Services</i>	9.3	8.4	\$425,857,143	\$38,400,000	\$ 76,577,561	3.0
<i>B2B</i>	9.7	11.4	\$173,600,000	\$13,618,793	\$ 68,194,109	2.8
<i>Business (internal use) Software</i>	10.6	15.3	\$260,911,765	\$10,340,000	\$ 22,612,941	2.9
<i>Consumer Hardware</i>	11.6	38.9	\$301,600,000	\$47,800,000	\$ 36,564,365	3.1
<i>Storage/Data Center</i>	13.4	13.6	\$450,800,000	\$25,000,000	\$ 35,750,246	2.9

Average M&A Value: \$277,345,485
Median M&A Value: \$100,000,000

Average Capital Raised: \$32,128,461
Median Capital Raised: \$15,550,000

CAPITAL RISK: COMPANIES EXITING VIA M&A RAISE \$15M TO \$20M FROM INVESTORS

Median Amount Raised Prior to Acquisition and Median Acquisition Price – 1996 to 2016



Source: Dow Jones VentureSource

HIGH VALUATION: A TWO-EDGED SWORD

POSITIVE

- Less dilution to management and existing investors
- Evidence of progress
- Bragging rights
- Everyone feels great!



NEGATIVE

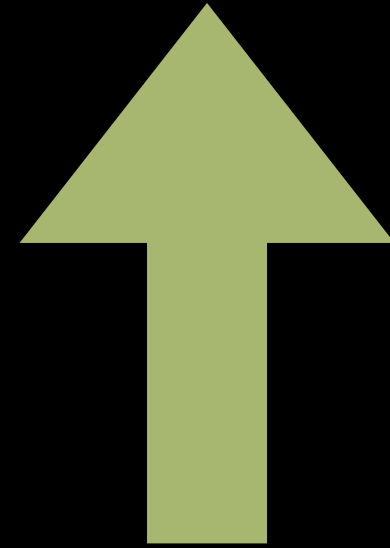
- May scare off future investors & M&A bidders
- If not based on rational, real metrics & milestones, next round may be a down round
- In future down round, investors & management get crushed

WHAT MOST FUNDRAISING NEGOTIATIONS HAVE IN COMMON

- Identify Risks, start with a fact-based baseline set of terms and valuation:
 - Pre-revenue: Scorecard methods
 - Use EV or Sales multiples
 - Recent M&A exits
 - Recent comparable financings in this sector
- Investors add **uppers** that reduce risk & subtract **downers** that increase risk
- Determine if proposed terms and equity ownership can make investors money
- Negotiate a final, fact-based term sheet addressing identified risks

THE DEAL NEGOTIATION

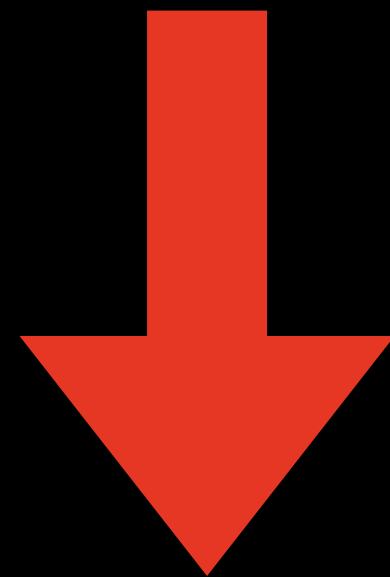
Management
says:



- CEO made \$ for investors before
- Large market, “hot” sector
- Strong culture sharing a common, game-changing company vision
- Strong book of business, low customer churn
- SaaS-style business w revenue visibility
- Increasing sales force productivity, decreasing Customer Acquisition Cost (CAC)
- Strong, protected IP
- Recognized market leader
- Strong references and proof of value and ROI
- Realistic, pragmatic management team right for executing this business
- High exit values in your sector and multiple paths to exit for you
- Market-making revenue partnerships

Revenue multiple factored by “uppers” and “downers”

Investor says:



- Techno-idealists w/o business skills; product people lacking market people
- Weak sales performance, regularly miss revenue targets, increasing CAC
- Inexperienced, non-metrics driven team
- Poor business execution
- On-premise-style traditional software business with little revenue visibility
- Not on path to profitability; flat or declining revenues
- A “me, too” company not recognized as a leader
- Investor cannot validate key business & revenue assumptions
- Weak book of business, high churn, low customer loyalty
- Market has few potential M&A buyers who can write a big check
- Slow business progress, little sense of management urgency

“PICKING AN INVESTOR IS LIKE GETTING MARRIED -- WITHOUT THE OPTION OF A DIVORCE” — EMERGENCE CAPITAL

- What are they like to work with? Fair weather or all weather?
- Do they look out for angel investors?
- Do they have deep pockets? How old or new is their fund?
- What kind of exit are they looking for?
- What are they like serving on a board?
- How senior is their lead investor?
- Are they Masters of the Universe jerks?
- Do they close the deals they offer?
- Do they honor their agreements, or do they make last minute demands before closing?
- Are they truly value-added?

- ☐ Interviews
- ☐ The funded.com
- ☐ Crunchbase
- ☐ Angel List
- ☐ LinkedIn
- ☐ Investor networks
- ☐ Portfolio CEOs
- ☐ Dead investments
- ☐ References

GETTING TO A FINAL TERM SHEET

INITIAL DILIGENCE

- Examine value proposition, solution, company vision, recent metrics & milestones
- Review business plan & forward P&L targets

AGREE ON VALUATION RANGE

- Review competitive landscape and recent financings and exits in sector
- Choose appropriate valuation metrics (pre-revenue vs. revenue-stage)

DEEPER DILIGENCE

- Team, customer, product, market diligence; identify key risks and mitigation strategies
- Suggest refinements to company's business plan and metric targets

DRAFT TERM SHEET

- Refine valuation range, propose specific terms; do terms address risks?
- Returns analysis—does valuation support investors' financial returns target?

NEGOTIATION

- Fact-based, goal-based discussion of round goals, future funding, company progress, risks
- Negotiate valuation as one element of an entire deal structure / set of terms

FINALIZE TERM SHEET & VALUATION

- Draft deal documents for review based on negotiated term sheet
- Gain final investor approval of deal

HOW TO AVOID CONFLICT OR LITIGATION: BOARD & EXISTING INVESTORS

- Insider-led down rounds / cram downs
 - Fix: Independent director(s) review tough deals
- Conflicts of Interest Between Your Role as Director and Investor
 - Your duty is to the company and all shareholders, not your series, fund or group. Remember Your Duty of Loyalty!
 - Fix: Warn Board of potential conflict, affected Director recusal
- Naïve Board demands
- Areas of Board/Management/New Investor conflict
 - Type of security: priced equity, convertible debt, [un]SAFE?
 - Unrealistic valuation ask
 - Management re-vesting
 - Governance/composition of the new Board (Your Board Seat!)

HOW TO AVOID CONFLICT AND LITIGATION: COMPANY & MANAGEMENT

- Secret deals between management and a favored investor
 - Beware: management fundraising “bonus”
- Management & Board dilution and “re-ups”
- Uses of capital
- Fundraising accentuates mis-alignment between Board and management, between common and preferred, between preferreds with different economic interests, and existing stakeholders and prospective investors.
- If the Board doesn't build a strong culture of trust before a crisis hits, it is often too late when a serious crisis emerges.

HOW TO AVOID CONFLICT OR LITIGATION: DURING DILIGENCE

- Too many factual errors and material omissions during diligence kill deals
 - Misleading or false historical financials or purely speculative forward projections
 - Ignore GAAP rules for rev rec and poorly defined “sales,” “bookings,” “revenue,” etc.
 - Incomplete, poorly documented or inaccurate cap tables
 - Smart investors are held harmless from pre-money cap table errors—management and existing investors will take the financial and reputation hit
- It is OK if your company has imperfections. It is NOT OK to be dishonest, duplicitous or to fail to disclose key problems.
 - Rigorous metrics and milestone-driven new investors will discover “buried” problems within the first few Board meetings
 - Investors may not be able to get their money back but they can fire execs, sue Directors and replace a Board failing to exercise oversight
 - “But we didn’t know!” “Oh. So you are either liars, thieves or clowns.”
- The Board should approve all presentations and financials given to investors
- ~~Fake it before you make it:~~ False or exaggerated claims are a Board liability

HOW TO AVOID CONFLICT OR LITIGATION: CLOSING THE DEAL

- Ensure that closing documents (amended charter & bylaws, investor rights agreement, equity purchase agreement, noteholder agreement) accurately reflect what is in the signed term sheet
- Resolve ambiguities (pre- or post-money conversions?, who pays for increase in stock option pool?, type of anti-dilution protection)
- Double check equity share counts, order of preferences
- Don't sign anything you don't understand—it isn't “just legalese”
- Hire an experienced law firm with a “venture” or “emerging company” practice—and don't be afraid to fire an incompetent one

NEGOTIATING THE DEAL: COMPANY (MANAGEMENT & BOARD)

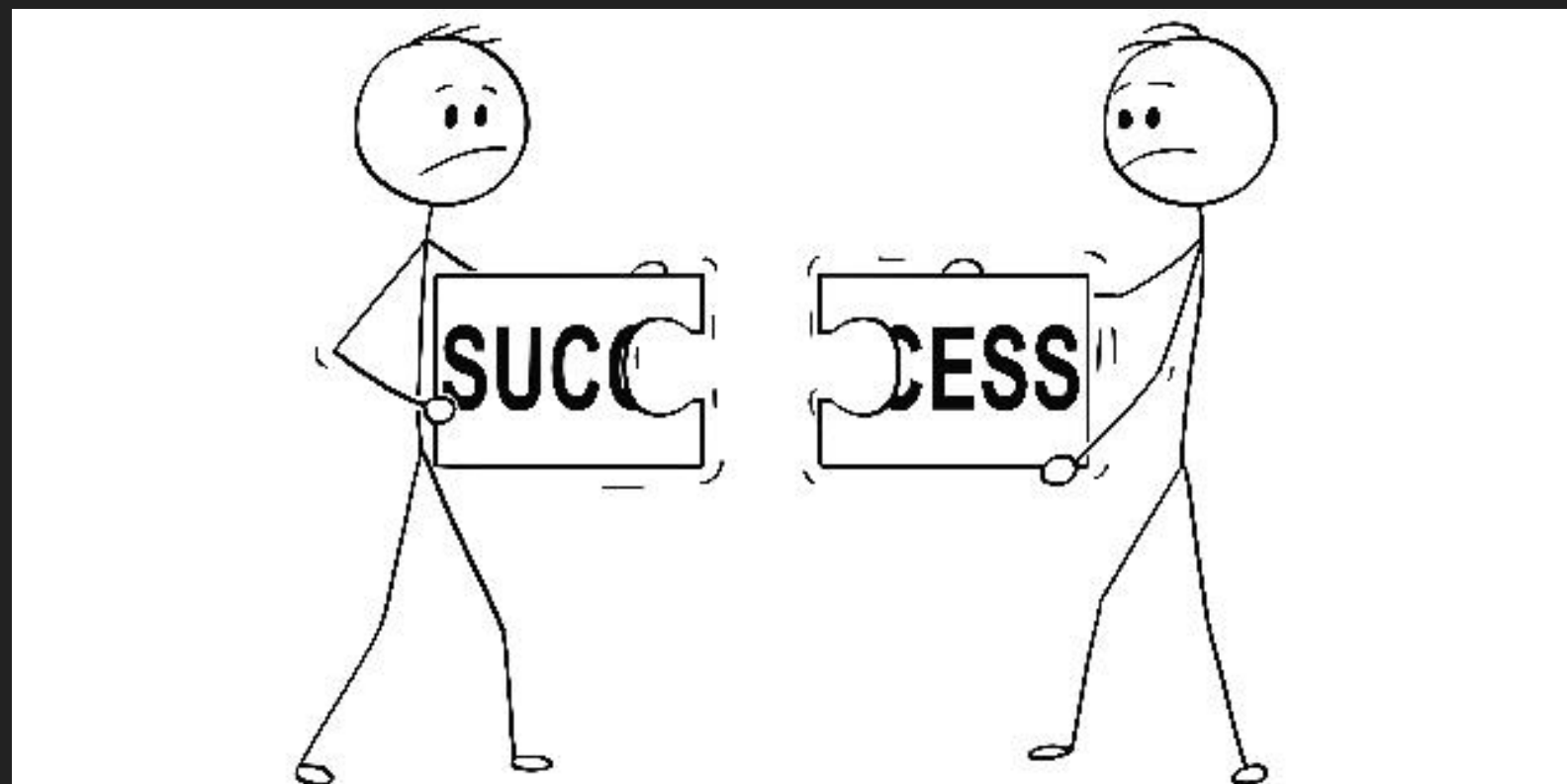
- The Board should justify its deal “ask” by being fair and fact-based
- Understand deal terms trends, multiples and exits in your market
- Understand how investors use term sheets & valuation to handle startup risks
- Understand how investors calculate their investment returns
- Your prior round valuation is irrelevant to new investors
- Overly generous deal terms may be inherited by future investors
- Don’t make future valuation promises to current investors
- A high valuation is not a merit badge—if too high, it can hurt your company and increase your future financing risks
- Remember: **valuation is negotiated in the context of the entire deal**

NEGOTIATING THE DEAL: NEW ANGEL INVESTORS

- The best valuations and term sheets are fact-based
- Like arms treaties, “trust, but verify” “facts”
- Explain your rationale for terms and valuation—and key disagreements
- Negotiate, don’t “demand”— be ready to compromise
- Investors typically scale capital and valuation to likely outcomes
- Don’t be greedy—anything you ask for now sets a precedent for future investors (like multiple liquidation preferences)
- Don’t disincentivize management with extreme demands
- Don’t be afraid to walk from a deal over indefensible terms or valuation

FUNDRAISING FAILS

- High valuation unsupported by facts
- Lack of progress against milestones and metrics
- Over-shopped deal
- “Sudden” cashflow crisis limits runway
- No investor interest



ROOT CAUSES

- Lack of experienced Angel director
- Investor-hostile deal terms
- Weak story, limited investor rewards
- Unrealistic Board-approved financials
- Poor cash planning and weak Board oversight
- Board won't participate in round
- Prior Board-approved rounds make company unattractive or give insiders blocking rights
- Board-approved partnerships make company a captive or limit future M&A opportunities
- Board lacks strong syndication network
- Board/CEO arrogance or failure to read market trends and signals

THE BOARD'S ROLE IN FUNDRAISING

	Management	Board of Directors
Identify Investor/Buyer Targets	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Hire (if necessary) "Twin Track" i-Banker, Law Firm	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Develop Pitch & Financials	Develop	Review
First Contact with Targets	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
First Meetings	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Negotiate	Primary Contact	Monitor Thoroughly
Diligence	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Review & Accept Term Sheet	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Satisfy Closing Conditions	Execute	Monitor Thoroughly

Questions



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Gold Partners



Silver Partners



Bronze Partners



K&L GATES



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- **Navigating the Climate Tech Hype Cycle** – separate hype from reality in this real-talk session focused on the rapidly growing climate tech industry, including details about how government incentives can impact your investing decisions.
- **Getting the Deal Done Globally** – technology continues to reduce geographic barriers for investors but are you ready to take on an investment outside of your home country? Our experts will present case studies and lessons learned on getting deals done in a global economy.

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