QuickLaunch University Webinar Series Transcript Seed Fundraising: How to Get Organized, Attract Investors and Negotiate Your First Round

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Presented by WilmerHale Partners Jason Kropp and Jeff Stein and Sigma Prime Ventures Managing Director Jere Doyle

Welcome to today's QuickLaunch University Webinar. This is Jason Kropp speaking. I'm a partner in WilmerHale's Corporate Practice. Over the last few months, we've explored a variety of different legal issues faced by entrepreneurs and early-stage companies as they begin to build their companies. Today, we're going to explore the early-stage financing process and look at how to get organized, attract investors, and negotiate your first round of fundraising. If you're interested in going back to listen to any of our previous sessions where we covered the basics of forming a company, founder equity, and other topics, the links to those recordings are posted to our website, and the links were included in the confirmation email you received.

Before we get started, we have a few housekeeping items to cover. First, let me quickly introduce our speakers. Again, I'm Jason Kropp. I'm a partner here at WilmerHale. My practice involves advising tech and life sciences startups and venture-backed companies, which are public companies in early and late-stage, investors and underwriters. I'm very pleased to introduce my two fellow panelists here today. Jeff Stein is a corporate partner in the Boston and New York offices of WilmerHale. He represents rapidly growing companies in the various tech, life sciences, consumer sectors and beyond. He's completed transactions for companies at all stages of development, from equity and debt offering, acquisitions involving multibillion-dollar global enterprises, and work for entrepreneurial technology and life sciences startups and their investors. Welcome, Jeff.

Jeff: Thank you.

Jason: And sitting here with us is Jere Doyle. Jere is a managing director at Sigma Prime Ventures, but he's really a proven entrepreneur experienced in building profitable and sustainable companies into recognized industry leaders, as well as an adviser to countless boards and management teams. He serves as an angel investor and as an adviser to a number of companies, and we're very pleased to have him join us here today for our discussion. Welcome, Jere.

Jere: Thanks and thanks for having me.

Jason: Looking at the agenda for today's webinar, we're going to talk through a number of topics that are quite relevant to the early-stage financing process. First, preparation. Second, we'll talk about sources of capital and different ways to think about them. We'll talk about a few different early-stage financing alternatives. We'll spend a bit of time talking about how to close deals. We'll spend a very small bit of time talking about the legal and regulatory overview. And we'll finish off with some do's and don'ts toward the end. And again, feel free to submit questions using the Q&A button, and we'll do our best to answer those.

First, preparing to raise capital. Jere, when a founding team or an early-stage company is looking to raise capital, they're thinking about launching a product, or acquiring customers, or building an MVP. What other goals are front of mind as you're talking to companies and founders about what they ought to be thinking about when they're embarking on raising capital at the early stage?

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Jere: I think when a founder is putting together their seed round, it's really when everything is coming together. It is a lot of balls in the air and a lot to think about. And, I think the key is, first and foremost, you have to stay focused on the business because without the business coming together, you're not going to get the seed funding. Most important is to keep the product development going, to keep the customer conversations going and to get that team together. But at the same time, you've now realized that you have a real business, and you've probably put a little bit money of your own in, you've bootstrapped it yourself, so now it's time to raise that first round of capital. You want that round to last you somewhere between 12 to 18 months. And so, you need to put together the parameters of how much you're going to raise and have a general idea, which I think we have to get into as far as who are you going to go after for that money, and then begin the conversations, really relying on your network to get things rolling. But I think, most importantly you have to understand you have two or three balls in the air. It's not just a fundraising ball. You've got to keep that company vision and that company creation moving.

Jason: Jeff, you obviously advise lots of founding teams on their seed financing. Are there key goals that you advise them to keep in mind as they're going through the process?

Jeff: Well, from a legal structural perspective, the primary goal is to get it done. It really means find investors, put together a structure that can be done as quickly as possible that's not going to surprise anybody in terms of what you're proposing, and most importantly is going to not complicate matters as you go forward. If the company continues to grow, you want to make sure that the earliest stage financing that you've raised is from people who understand what the process is, are willing to accept terms and conditions that will leverage their way into future financing so that it all becomes easy.

We've identified several of the key factors. For example, seeking sophisticated value-add seed investors. Go to the people who understand what investing and seed capital rounds really mean. It may not necessarily be someone who knows the industry as much as someone who knows the early-stage world. For example, we recently had a situation where an early-stage company was trying to raise seed financing for a real estate platform, and they went to real estate investors. And that really was not a good structural fit because real estate investors were expecting all the sorts of investment returns that people get when they invest in real estate. And what they really needed was someone who understands the technology investment world. It's really important to keep in mind that there are people who understand the space, and those are the people that you want to talk to.

Jason: One of our key points is "Don't create future legal and other hurdles." The way I think about these financings in many respects is that you're laying a foundation for what's to come. Focusing on the KISS principle, "Keep it simple, stupid," is something that I bear in mind as I'm structuring transactions like this. And I look for ways to eliminate friction and to avoid creating friction for future rounds as well.

Jeff: I talk to a number of different people who all have different ideas about what the terms ought to be, and it's really important to try to bring it all to a single set of terms so that you're not negotiating with different people at different terms. That makes for a really difficult future for a company.

Jere: The other thing I would add to what you have said, Jason, as far as the future, is it's hard to think this way, but as you bring together that first round, you need to think about the milestones you want to accomplish with that money that gets you to the next round. You're just about to go out and raise your first round, $1 million, $1.5 million, and you have to think about how that is going to last you 12 to 18 months, and what are you going to do with it, and what are you going to accomplish, and what are you going to be saying when you sit down in 18 months to raise that next round. I think that really will drive a lot of what's discussed in the conversations with your seed investors.

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Jason: We'll come to a little bit more discussion about how much to raise later on. But before we go there, Jeff, in terms of founders and management teams that are preparing to get a financing going, what suggestions do you have for them from a legal standpoint in terms of preparing?

Jeff: I think the key here is to recognize that investors are making a decision based on what they think the company is worth in terms of future value. And when they're doing that, they're making assumptions as to what the company looks like. They're making assumptions that you own the IP you think you own, that the equity is owned by the people who you say it's owned by, that the employees are all being classified appropriately, all the places where value is assumed to exist. Your potential investors are going to spend the time making sure that it does. And so, don't assume that they're going to miss those sorts of issues. What you ought to do, what any founding team needs to do before they start to raise money, is to make sure that you look at the company the same way that an investor will look at the company, so that you recognize where all the potential issues are, and then just deal with them. It doesn't mean you have to clean them all up. It just means you have to understand where the risk issues are from an investor's perspective, and make sure that you have a good story as to how you'll deal with them so that, as I said, the investor can put money in based on certain assumptions they're making as to future value opportunities and feel good that the value is not leaking out in unexpected ways.

Jason: In terms of other kinds of preparation that their founders ought to be making at this point, Jere, one of the questions that we've received from folks who are participating in the webinar is, what kinds of financial information a team should be prepared to provide to seed investors at this time? Do you have a thought on that?

Jere: Well, I would say, just my own view, not that much. At the end of the day, you're talking first round of funding. This is way more about the people than it is about the numbers. Obviously, you have to have a financial plan, you have to be in a big market with a really great opportunity for scaling because that's why outside investors want to invest—because they want to be able to see that the business is going to scale. But it really is about the people, and what you've done, and your track-record and your capability. I wouldn't spend a ton of time cranking out spreadsheet upon spreadsheet of numbers because so much is going change. You're in the early stage, you've got a concept, an idea. Maybe you have an MVP product, a couple of beta customers. You have no idea what the next three to five years is going to look like. When I get these plans and they have these ridiculous projections out five years, I ask, "Why did you spend the time drilling down?" You need to have the big picture, yes. But I don't think you need to spend tons of time figuring out cash flows and that kind of stuff.

What I do think you should understand is what is your cost of acquiring customers—I think that's really important. Know what your plan is going to be to acquire customers and about how much that's going to cost. Figure out what your lifetime value to that customer is going to be. Talk a little bit about sales productivity. Those are the kinds of things that an early-stage investor wants to know. Back to your initial point, keep it really simple, it shouldn't be that complicated.

Jason: Another question from the audience. "Is there any particular magic that you think about when you think about the size of a company's team? 2, 3, 4, 10 founders? Is there any magic you think about there?

Jere: There's no magic. Ten founders will be a lot of founders. It really depends on how long they've been together—a company that has come together in the last six months or so will probably have two or three founders at the most. Some of the companies that have bootstrapped for a little bit longer, maybe two or three years ago, they've got a team of 10 or 12. Again, it's usually only two or three founders. I prefer to have more than one founder because I think that's a good thing as an investor—you've got backup. But I think any more than three becomes pretty complicated.

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And I've seen in the past where two-person founding teams have issues. There is no magic number. But I think it's good to have balance If you're a building technology company, it's really good to have an engineer on the founding team Obviously you need a business mind or sales and marketing. Or it's really important if you're in the life sciences to have some background in life sciences as part of your founding team. But I've seen teams where they're all scientists and no business minds. I think real balance and diversity is important.

Jeff: And it's natural. And there was an interesting study in "Inc. Magazine" recently that they looked at the sizes of founding teams and tried to correlate it to success. And surprisingly, because I think it's inconsistent with what most investors say, single-person founding teams have almost the same percentage rate of success in terms of exits and that there was a surprisingly high rate of success for single-person founding teams. So that's interesting.

Jere: Very interesting. You often see one founder and then maybe a couple other kind of co-founders. You've got one person that's driving the bus, and you have a couple people in the passenger's seat. And I think that's good. But I think if you start slicing up the pie in too many pieces, it could be troublesome. It kind of goes back to your study.

Jeff: We should stop on the last point, a singular documentation, a central repository. I think it is so key for founding teams to have a good organizational structure for essentially all the documents. And the sooner you start with that process when it's really simple, the better off you'll be. And so just actually assembling all your documentation, the central repository, even when the company first gets started, before you've started a financing push, is really important because it's going to be something that you can then just turn on for investors when you go forward.

Jason: Totally agree. We'll try to avoid plugging, but that's a very important aspect of the service and experience outside counsel provides.

Jason: Another question that came in, is there a list somewhere for the type of documentation that ought to be retained and provided? Jeff?

Jeff: Yeah. Well, so your lawyers can certainly give you what would be called a standard due diligence list that investors would likely ask about. But if you think about it from your own perspective, if you don't have that list from your lawyers yet, it would just be all of the issues that you think about in terms of what creates value. So, all of your equity records, all of your agreements, all of your consulting relationships, any legal documentation certainly you'd want to be keeping in a single place.

Jason: This is that time that experienced investors are going to look at that documentation, and they're going to look for gaps in IP ownership assignments, for example. Making sure that the company has been rigorous about that from the start, and identifying those jobs as you've mentioned earlier, in advance of an investor identifying the gap is obviously part of it. Thinking more about the raise itself, we started to touch on this, both with respect to proceeds, and planning for the future, and even team. Jere, do you have thoughts on how a founding team ought to think about the size of the raise that they're embarking on?

Jere: I think today you're seeing founding teams raising less to start than when I had my first company 15 years ago or so. I think it's really about what are you going to do with the money. Again, where do you want to get to—if you're going to raise a round of a capital to start your business, where do you want that to take you? What do you want to be saying? You imagine yourself at the table 12 months from now or 18 months from now, what is the story going to be then? Picture yourself in the future, picture your company in the future. It really depends on the business. But how much is it going to take to get there. If you're in a beta situation and you want to get the product launched, and you want to get

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10 or 15 or 20 customers, and it costs you in the sales process—if you're selling to big enterprise, it's a 6-month or a 12-month sales process, then you're going to need to raise little bit more. If you're in a situation where the sales cycle is less time and you're not going to need to put as much planning on the sales and marketing, and you don't need a huge engineering team, then you can raise less.

It really depends on your situation. What's popular now is kind of like a seed, that seed extension. So, really where do you think you're going? And I think that answers the question as far as how much I want to raise. There's no right answer here. I think on average, probably you're seeing rounds, your first round anywhere from half-a-million to maybe $1.5 million. I don't understand when folks come in and pitch me and they say they're raising $5 million in their seed round. It's just really unusual. It doesn't happen anymore. In 1999, that was the kind of thing that was just happening.

Jason: So along those lines, is it possible for a company to raise too much in their seed round? A total absolute nice problem to have.

Jere: Well it is and it isn't, because if they raised too much, they then go out and spend too much and they've spent it on things they shouldn't be spending it on. I think you need to raise just enough where you still say you're careful where you spend the money because as soon as that money gets to the bank account, you know, "Now, I need this extra person. We're going to run this extra marketing test or maybe get engineers," and sometimes it's not spent so wisely, and you're still figuring it out. Most companies, when they're raising their seed round are still figuring it out. They're figuring out their products. They're figuring out the product-market fit. They're figuring out the pain points, how to sell, the sales process. And, a lot of those first employees that you hire don't work out. They don't have that same fabric, that DNA, the founding DNA that you have. So, you can definitely raise too much money.

Jason: Essentially, at the same time, you need to, as a founder, plan on those mistakes, right? And so, you might think that $1 million is going to take you out 18 months. But if it's just going take you out to those 18 months, you ought to plan for a little bit more because there will be surprises, there will be things that cost more than you expect.

Jere: It will always take longer. There's no doubt about it.

Jeff: I think another thing to keep in mind is that every stage of the company has a different group of investors, right? Back when I started, same thing, Jere, the initial group of investors was a series A investor, but that's because you needed to spend $3 million on the servers to get your product going. Now with AWS, you can do it for $89 a month or free or whatever, right? So, you didn't need to do it. Now the earliest stage investors are angel investors, and then it's a seed investor group, and then it's a series A investor group. And the issue is always making sure that when you're raising capital, it's enough to get you to the next investor group. I see it all the time that the clients that are looking for seed capital are actually having conversations early stage with series A investors to know what it's going to take, what they have to show to get series A investment. And that's sort of how you look at your 18 months, which is, what do I need to do to get to 18 months? Then you need to factor in the unknown because you don't want to be at 18 months and not have gotten to those metrics, but then you're in a situation where you're coming back to your seed investors for different terms, it's a different sort of situation.

Jere: I totally agree. I think it's really helpful if you can have some conversations with later-stage investors to find out what they'll be looking for. The other thing that the later-stage investor will do is they'll see where the audience was, you know, personal relationships or introductions, they'll also turn around and introduce you to the C-pack, right? They'll make the introductions because they're seeing those deals. So, they're seeing the people who are investing in successful early-stage stuff. And that can be a great way to get introduced to angels and to seed funds.

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Jason: So, either we organized these slides really well, or you guys are just natural segue creators because our next topic here is who do you ask for money. Jere, as you think about founders going out into that network, trying to create that network, what kind of advice do you give to them at that point?

Jere: Well, I mean it's not easy, right? I think you do have to rely on your network, or your co-founders' network, or if you have friends and family who brought money into it or early stage money from your existing investors' network. I think most importantly you have got to know your audience, right? So just like when you're selling and you know your customer, you know that they potentially bought something from your competitor, or they're in your space, and I think with investors, it's the same thing. You've got to do your research on the angels, or on the seed funds, or the angel groups, or on the accelerator, wherever you're going. You've got to make sure that they're playing in your space. And it's pretty easy to do that research now with LinkedIn and Google and all the different publications that list out investors. But I think most importantly is know who's writing the checks, and then go talk to folks who are investing in your space and get introductions. I very rarely will answer a cold email—because I figured if you're not good enough to get someone to introduce you to me, then you probably are not my kind of entrepreneur. Get introduced to the people who are writing checks in your space. Get introduced to the funds that are playing in your space. Don't waste your time talking to investors that aren't. I don't invest in biotech. So, it's pointless to come talk to me about it because I don't understand it. Don't waste your time talking about it. I think that's most important. It's finding out who's writing the checks in your space, and then try to figure out a way to get introduced to them.

Jeff: And understanding the stage. Again, I'm going to go back to my stage comment, which is understanding who's investing at this stage of company development because it could very well be that you're talking to people who you know have invested in your space but it just may be that the company is too early for that conversation. And it's not that they're bad people, they don't like the technology, they don't like your team, they don't like the company, it's just that they're not focused on investing in early-stage companies. And I think, Jere, it's something that you and I were talking about before here, which is how to understand when someone says no. First of all, how do you know when someone's saying "No" and how do you know when someone is saying "I'm not sure?" How you really interpret the message is important, and also how do you not get discouraged by the no or when oftentimes a no may be accompanied by a, "Yeah, your business doesn't look so good," or, "If you need to change it this way, maybe you'll be more interesting." How do you sort of avoid all the distraction?

Jere: I think you've got to try to disarm the potential investor because it's hard as an investor to turn people down, to turn companies down. I meet with 20, 25 companies a week so I have to say no a lot. And that's hard to do, right? Because you feel badly and I think if you can disarm the potential, prospective investor by really letting them know, "Look it's okay if you say no here. But, do you know other folks to introduce to you. Maybe this isn't the right space," or "What don't you like about this business? Could you give you some feedback?" I think the fundraising process should really benefit your business. Number one, you get great feedback, real-time feedback from hopefully pretty smart people. Number two is you get introductions to other folks, you get introductions to potential clients, because a lot of times as an investor, you want feedback from somebody in the space. So, make the whole fundraising process a real benefit to your business. And I think that you do that by being a great listener, and by asking questions, and disarming folks you're pitching so that they don't feel badly saying no to you. And they'll always try to, "Look, I'm not interested in investing today, but I'd love to help you in advance." While they're taking the meeting, they're listening to the pitch because they have some interest in this ecosystem. I said no and so many times I want to help, I want to point you in the right direction, and then maybe if that works, then maybe you'll come back to me, you'll make some progress, and then I'll look at it a second time.

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Jeff: How do you think, Jere, when you act in your advisor capacity, how do you suggest to companies that they get organized for a financing? I've heard people say just treat it like a sales process. Create a spreadsheet. List all the potential investors that you think are in your space at your stage. And put down what you think the ask should be. These people $500,000, and these are family funds, these are smaller, maybe$50,000, the next group $10,000. To have enough, and then treat it on a very methodical basis? How can you suggest to help people understand how to actually do a financing?

Jere: I think the most important part of doing the financing is to find somebody to lead it. I would really be very focused on that area first. As you group people you're talking to, you have three groups, I think. One group is people who aren't interested, I mean most of them, but you hope they'll push in the right direction. The second group is the folks who you think would come along for the ride, but they're not going to be the lead, and set the terms, and ready the first set. Then that third group is the folks, and that's a small group, that would actually lead the round, and set the terms, and put the first money in and write the first check. I think those are the ones you need to focus on at the beginning because it doesn't do any good otherwise and in some ways, it can really slow things down because that second group is really large, but you don't have any lead yet because you're going back to them on a regular basis. And they're waiting for that lead, they're waiting for me to set the terms to write that first check. I think by understanding where your folks land in which one of those buckets, will help you stay very, very organized because otherwise, it can be a very time-consuming journey. And ultimately time is really your most precious asset as a start.

Jeff: And how do you find the lead? A lead investor is someone who's willing to negotiate the terms, do the diligence, and basically take responsibility for what the financing is, and set the timing, right? That's how I would define, as a lawyer, a lead. So now you're saying find that person first. How do you do that?

Jere: Well, I think, again, it goes back to making sure you know who you're talking to and asking them that if they lead this, they will be one of the first to be in or I'm trying to get a group of three or four to lead this, or one person to lead it. If you search out the super angels or the angel groups, there are a lot of these funds that are now doing seed investing that are pretty small. Their decisions are made by one partner or two partners. And the really good seed investors will give you an answer pretty quickly. Working the last three or four years, I know which seed investors are the ones that will lead or won't lead. And if you've already met with the fund and it's a month down the road and you don't get them to write a check, then they're not going to lead. And that's okay, move on to the next one and by keeping them, you find out if they could good stay in that second bucket or not, that maybe they'll participate.

Most of the time a lead investor will give you some really good feedback about what they need to see in order to sit down and write a check because they don't waste their time either. We're all busy, everyone's busy looking at deals. What I need you to do is have a couple customer calls. I need to see one of these guys buying this. I need to see if this person, this product be launched. They'll have their to-dos that need to happen. And if I'm going a lead round, I'll basically put together a list of two or three things I want to see happen. A lead investor wants to see traction. And you need that traction or create the inflection point, get somebody to jump. You need to create urgency. I'll give a potential lead investment for me, I'll say, "Okay, let's see this contract get signed, or let's see this product get launched." And that then gives me the impetus to do something, right? Investors like motion, and so I think if you walk out of a meeting knowing the two or three things you have to do in order to get that lead done, you're in pretty good situation, if you accomplish that stuff, you may get that lead versus it's kind of nebulous, it's kind of out there. I may do it, I may not, they usually, probably are not going to lead the round.

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Jeff: It’s probably worth clarifying that when we're talking about seed, seed means progress as opposed to a seed that we're just starting. Because seed investors these days, there's a lot more traction that's required than sort of intuitively when you think of seed investors as someone who would write the check on a business plan.

Jere: I think writing the check and the business plan is really the friends and family round. I wouldn’t call that the seed round. You’ve won some money—there's a lot of places to win money, or to get grants or you get the friends and family. I think the seed round is where you've got this MVP product that's built. It's more than just an idea. It's not a finished product, but there's something there. There are customers that are kicking the tires or driving the car around. There's definitely some traction and things are in motion.

Jason: Every once in a while, you do see a proven entrepreneur starting with their second company or their third company, and it's really nothing more than an idea. You do see that every once in a while, but that's a really special case and those folks have their networks built. Jere, when you've got that warm introduction and you've taken the meeting, are there particular characteristics of a company or a team that cause you to want to take that next step and think about writing a check?

Jere: Well, I think, obviously your experience is important. I mean it's the DNA, I think, of the successful entrepreneur. I can usually tell in the first five minutes of the meeting whether or not this is an entrepreneur that I want to work with, that I want to back. The thing about a seed investor is this is a 10-year journey—for a seed investor to go with it, you’ve got to really have some good karma, and it’s good to have great atmosphere in the room. I don’t think it’s any one trait. From talking with entrepreneurs over the last 10, 15, 20 years, I just get a sense of who I think is successful or not. And obviously, the experience is important, and the diversity of the team is important.

I'll tell you another thing, it's how concise they can be with the way they describe what problem they have and what they do. I get into a lot of meetings with early-stage companies where I'm 20 minutes in asking "What do you do?" Please don't make it sound too complicated. I think a lot of a lot of early-stage companies try to make their solutions seem so complicated because they think that investors want to invest in complicated businesses because that's going to be a real winner. And I think it's exactly the opposite. Early-stage seed investors want to invest in something they really understand. If I don't understand your business, I'm not going to invest in it.

Jeff: Jere, how do you go from an email submission to deciding to take a meeting with the person? What’s the magic switch in your mind?

Jere: If I get an email from somebody I know that says, "Hey, you should meet this company." And ideally, there's going to be some pull-ups about the company that I'm going to be able to understand real fast. And maybe a one-page summary or a two-page summary at most about what the business does so I can look at it and quickly say, "I get this. I understand." I'm always shocked when I talk to an entrepreneur that doesn’t have a one-page summary of their business. That’s the first thing you've got to do is put it all down on one page and explain. From there, I'll do a phone call. A 15, 20-minute gut check phone call, tell me about this business and I'm listening there, to what I just talked about, twenty minutes on the phone, can I get a pretty good understanding of what this business is? What are the pain points? Why is this going to be important? How easy is this going to be to sell to customers? How long is it going to take? How much money are they going to need? What’s your experience as an entrepreneur? And if I go through that phone call well, then I'll do a one-on-one meeting where I want to hear it all over again. What I don't want is a 15-page text sent to me, that I have to sit through on my own and try to understand. That's not how I do it. That's just me personally but I do think most investors kind of operate under that as well "Give me the simple summary. Let me talk to you quickly," and then I'll do a meeting.

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Jason: And one last question from the audience before we flip to the next topic. Jere, you meet someone at a cocktail party for three minutes and their simple question to you is, "I'm trying to meet seed investors, where do I start?"

Jere: Well, you're at the right place. First of all, I'd say you're right, you're there, you're at the right place, you're at a gathering, a cocktail bar, a demo day, whatever it is, and you're having the conversation. Get their email address, get their cards and make sure you make an impression to say, "Would you be interested?" or "Do you know anybody else that would be interested?" Because the early-stage investors all know each other and we'd love to make introductions to one another. I think that's where you start, you start with right where you are.

Jason: You’ve got to ask.

Jere: You’ve got to get out. There are so many [events] We're in startup month right now here in Boston. There has to be an event or two or three a night right now. You’ve got to go to them and put yourself out there and that's the great thing about what's going on in the ecosystem right now. It doesn’t matter what city you're in, there are all these meetups, and these startup events all over these cities every night of the week.

Jason: So, our next slide is talking about the particulars of a financing. How do you advise folks to think about valuation? Jeff, do you want to take a crack at this?

Jeff: We’ve listed three bullet points that I think you probably wouldn't have any real idea how to value your company based on those bullet points because you don't have the metrics for it. There probably aren't any comparable companies. The exit value is something that's out there in the future that you don't know, and the net present value based on discounted cash flow, well, you wish you had some, right? So as a practical matter, these metrics are not that relevant, except that they are, I think, in the sense that it gives you a framework to feel like you can create a model. You can look at other companies that are in the space that you're in and you can look at what their exits might have been. You can look at what you think the cash flow might model up to. And you can come out with ways that you can rationalize a value and use that as a framework going forward.

I think I read somewhere, and this was probably in an angel context, there was some study done that a leading angel group had said that the amount of diligence they do if the valuation is above $4 million is significantly more than if it's lower. If it's lower than $4 million, they’ll write a check without even thinking about it because it's more conceptual. If it's over $4 million, they get into it that much more. So, there's no magic to that except it's out there—there's no science, I think. In many ways, there's no science to it, but there is math. And math allows you to feel like you're getting in a place that you can rationalize.

Jason: And we talked a little bit earlier about laying a foundation with these financings. Obviously, the valuation metrics that are used in a seed financing are foundational for the financings that are to come. Jere, do you want to talk a minute about that?

Jere: I think that is actually the most important thing when you're trying to determine valuation. You're laying the groundwork for 18 months from now. We talked about that for the last half an hour as far as what you're trying to accomplish, the milestones. But also, then picture yourself as across the table from your seed extension round to your A round, you're trying to raise $3 million to $5 million at an X valuation. And right now, A rounds are being done anywhere from beyond $7 million—$7 million to $15 million to $20 million. Look at your space and see in some of those rounds, you can get a really good sense of what the valuations are.

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And then project it. Say we'll do it at $3 million, and we're raising $1.5 million, it's $4.5 post, and we're going to come out in 18 months and my goal is to have going to have $8.5 million pre, almost double my early-stage investors' money on paper. That's why what I see all the time is the valuations and the seed rounds are set too high and all that's doing is making the bogey so much higher, and you're making the milestones much bigger. So, if you're going to get a $7 million pre on seed, and you're going raise $1.5 million, you're now at $8.5 million post, you have to be a double digits pre for your next round. That's what your goal is. You better make sure you're going accomplish a lot in 18 months. Get a product launched, get some revenue, not have any churn.

And so, what happens a lot of times is you don't achieve those milestones. And so many of the companies that have trouble getting to the next round, the seed extension, the A, so much of it is because they raise their seed up too high a valuation. And so, you're setting yourself up for a really, really difficult 18 months with some real high expectations. So, my advice is don't get so wrapped up in that early valuation because you don't want to get diluted, and think about what you're trying to do, what are you going to be pitching, and what are you going to say you'll accomplish to get to a certain valuation at your next round.

Jason: Let's turn to structures and different types of securities. There are four primary ways that we see venture-backed companies or companies that want to become venture-backed raising cash. Sometimes they incur debt, whether it's convertible like traditional bank loans. Bank loans are not available, but convertible debt is an instrument we see. Debt and equity hybrids such as a safe, which is like a convertible note but without that obligation to repay. Preferred and common stock. Do you think investors care what they're getting at this point, Jeff?

Jeff: It ties into Jere's last comment in terms of valuation expectations and the benefit of a convertible instrument. A note or a SAFE is that you can defer that issue until the future, although with caps it may be implicit in some way. But I think that there is a value in doing that, in raising money through a convertible debt or a SAFE instrument because you don't have to commit yourself to that value, and it kicks the proverbial can down the road, or the can down the proverbial road. Jere, from your perspective, we had always developed convertible notes. And then Y Combinator, I think, now it must have been 10 years ago, times goes by so fast, but this concept of SAFEs, which is a recognition that people, when they put money in on a future valuation basis, aren't really expecting to get paid back, they aren't really expecting to get interest. And so, let's just call it what it is, which is that hopefully this money will get converted into equity at some point down the road. It's been an instrument that's certainly used, but probably not as much as convertible notes. I know Jere has been an investor. Do you have a perspective on how people feel about that?

Jere: I know that some people don't like SAFEs and they refuse to invest in SAFEs. But then I've also seen them on the cap table. My sense is I've invested in plenty of SAFEs as well as convertible notes, as well as deferred stock, and I think it really comes down to the field, and the entrepreneurs, and who they are, and what they're doing as far as driving my appetite. But I don't think it's a big difference because, to your point, I think at the end of the day, if it's not converting, then that means the company's going out of business, right? I'm not investing in lifestyle businesses. I'm not investing in a company that takes 25 years to grow. I want a business that's growing quickly because they've been scaling. They're either going to be successful or they're going to run out of business.

Jeff: So the structure in many ways ties back to the first line, which was the goal of trying to get this done quickly and cheaply. And certainly, convertible notes and SAFEs, standardized instruments, don't take a lot of negotiation and can be done quickly and cheaply. I think from that perspective, that drives the decision more often than not.

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Jason: When you apply that lens, you take preferred stock out because it typically costs more to get it done. Common stock is not going to be appealing to investors because you ultimately sit at the bottom of the capital stock there. And as I started by saying bank and traditional loans aren't going to be available. So, you really do find yourself in that world of convertible debt or SAFEs.

Jere: It's a six-month journey to preferred stock versus a SAFE. I think a lot of early-stage companies that are raising seed are doing the first stock as well. I think it's better. It's always better to get a price, get everybody to understand what it is. It's much cleaner. I think it'll make it a little easier in that next round. The thing I'm worried most about when it comes to the convertible note is you know because it's so easy, a lot of times they'd be tacked on a second or a third round. That's really problematic because that, again, is just pushing it to make it so difficult to get that time, that price round time. You know, we come in, I hear at the A stage and I want to raise $3 million or $4 million at a $9 million pre, then I find out that they've got 3 convertible notes, each one for over $1 million, it's also that's $9 million pre, early $12 million pre. The post comes at $16 million or $17 million post. I prefer to price it out, but I do agree with what you're saying that it's quicker, faster, cheaper, easier.

Jeff: The conversion factors on the notes, sometimes when they layer on top of each other, they get really confusing as to what they really convert into, and it turns into a negotiation that sometimes is just a mess.

Jere: Some investors get a different valuation, a different cap than others do. I think the other thing you should stay away from is uncapped notes. I just think that really attracts the wrong type of investors. I would never invest in an uncapped note. Why would I? Why would you do that? Just wait for you to price it. You get a small discount, but why are you going to take my money, you're taking investors' money and you just create value, and all it's going to do is mean the investors are going to get less.

Jason: Thanks for answering that question because that was actually a question that was just raised by one of our audience members. Moving on, you've got investors around the table. You've worked to establish terms that you think work for the company. But you just don't have that momentum to get things done. Maybe it's because you don't have that lead or that lead's not paying enough attention. Jere, how do you get that financing going if you're the founder?

Jere: First, it goes back to when you start. Make sure when you start talking to investors, you're ready because these conversations go on for a long time. That's why there's no momentum because you've been talking about it for three months or four months or five months. Don't go out and actually restart your raise until you're really ready. And you're ready when you're close to an inflection point. You're ready when there's something going, when the motion is at its best. When the train is, and I always say, the train is pulling out of the station. Investors like paying. They all want to stand on the side and watch until one jumps. And as soon as one jumps, they all go. And so, you've got to get somebody to jump and you get them to jump by the idea—there's a fear I'm going to miss if I don't jump right now, and that's because there's traction. Start your raise at the right time, make sure that there's some momentum and you, as an entrepreneur, need to not have an ongoing conversation with the same folks. Learn how to say, "Okay, this person is not interested. I'm just going to stop talking to that person." And try to get to the point where there's some urgency, where you say, "I still haven't raised $1 million. I'm only going to raise half a million. I really don't think I need more than a half a million. I'm going to be oversubscribed now." If I was an investor and hear that I'd think that I better get moving. The investor learns so much by waiting on the sideline and it's really, really difficult to get them into that mentality of saying, "I'm going to now jump." You know, they're only going to do that when they have to write that check.

Jeff: How much of that conversation is good for the first meeting? When an investor comes in and says, "I'm going to close it. This is what my business is doing. I'm going to close it in a month, and here's the instrument." Is that useful?

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Jere: If you say you're going to close in a month and you come back to me eight weeks from now and say, "Oh, I didn't close," that tells me you've had trouble raising money. I think if you have your lead and you have the instrument, and you have the terms, and you said, "I'm going to close this out in a month. I'm really busy, I have a lot going on. I have customers. I have sales calls I have to make, I just can't spend any more time." If that means they're going to raise a little bit less money than that means you raise a little less money. I think you need to be ready to say that, be ready to do that. I think that's smart. That's not a terrible thing. Because I think at the end of the day, you'll find that if I'm interested and you tell me you're closing this in a month, you've got the terms, you've got the lead, you're all ready and you're doing it because you're so busy with customer stuff and building a product, I love that.

Jeff: And when someone comes to you and says, "Will you be willing to lead this round?" Would you rather that they have the term sheet with them saying, "This is what I'm going to sell," or would you rather have the ability to tell them what you want to buy?

Jere: If I'm going to lead, I should have to go and at least shape what I'm buying.

Jeff: So, it would be better to just come in and say, "I'd like you to lead, and let's talk about what you would want to invest in before I give you a term sheet?"

Jere: I guess I'll say, "So what is it going to take for you to lead this? How do these people work?"

Jeff: And what's your answer to that question?

Jere: I think a couple of things. I'm probably going to throw out a valuation because we know that in 18 months you're raising exit Y so I'm thinking around this range, how does that feel to you? I'm probably going to do this chunk of it, and let's see what other co-investors do you think you have. We always like to have a co-investor at the table, and hearing who else they think is going to be involved. If I'm willing to lead, who else do they think will come in right away. I think that's important.

Jeff: And how long does it take you to come back with a valuation. When you say, " I'm thinking of a valuation. at this rate," is that a first meeting conversation, or does it take you a week to go back and understand the market?

Jere: Personally, I'm going to throw a valuation out pretty early, I actually want them to, or I'll ask. Many times, they'll be in a phone conversation. What are you thinking for a valuation? What percent of the company are you looking to sell? Maybe I don't give you the price exactly. You're saying, "Okay, you're going to raise $1 million, $1.5 million, what are you going to sell in the company?" If they tell me 10%, I'm probably not going to invite them in. Because I'm not going to invest in something over $10 million pre. I think that I've already got a sense. But just like an investor, that's what the entrepreneur needs to have, too. They should have some questions, too. Their time is just too precious, if not more precious than the investor. Don't go into a pitch without knowing that I'm not going to invest at north of a $10 million rate, you're wasting everybody's time.

Jason: That goes with "Shark Tank."

Jason: Jere, one of the questions I get asked a lot is "we need funds in order to get some traction with our first customer or with the technology, but we also need that first customer or traction with the technology to get our first funds in." What do you say to that founder who's got the chicken or egg problem?

Jere: You've already had conversations with potential customers even as a founder, so you should know that there's some pretty good traction. As an investor, my due diligence is to talk to customers and

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potential customers. If you had some conversations with potential customers as a founder, and you can give that customer name to me, and I have the same conversations, and they say, "Yeah, I really like this. This is really cool. I can't wait for it to get launched. I'm excited about it. I understand it." That gets me pretty excited as the investor, right? I don't think you have to have the thing launched yet to raise your seed funds, but I think you should talk to the customers. A founder who hasn't been talking to customers, potential customers, that's a problem, right? How do you know what they want? Those conversations should always be flowing, and I think you should have some of those customers that you're willing and ready and able to introduce to potential investors.

Jason: Jeff, do you want to talk a little bit about how the securities laws overlay on to what we're talking about here?

Jeff: What we're talking about here in terms of capital raising is selling securities, whether it's convertible notes, whether it's SAFEs instruments, whether it's common stocks, whether it's preferred stocks, it all fits under the definition of securities for federal and state securities law purposes. And really, the bottom line on that is that means you need to involve your lawyers when you think about fundraising. And that includes, not only closing the transaction, but it also includes the manner in which you identify investors. There are certain exemptions that are available for fundraisings that you need to be aware of under the federal securities laws. If the exemption is not available, then it qualifies as a public offering, which has to get registered with the Securities and Exchange Commission, which obviously isn't what you have in mind. And so, you need to make sure that you are compliant with the applicable exemptions that are available. And that's a process that you need to discuss with your lawyers.

Fundamentally, it probably means that you should limit your investors to people that qualify as accredited investors under federal securities laws, which means, in just the briefest of terms, that they either have a net worth, not including their homes, of over $1 million or income over $200,000 or $300,000 jointly with their spouse. And you really ought to limit your investment approaches to people that meet those qualifications because it'll make the fundraising process much easier.

Jason: We can go to the next slide on crowdfunding. And this coincides with a question that just came in—we won't talk about the particulars on the legal aspect here on the slide, but Jere, I'm curious what your thoughts are on the sort of trend toward crowdfunding. Are you seeing more and more of it? Do you think it's appealing? Are you getting involved?

Jere: I'm not involved. I've been on a couple crowdfunding platforms just to be a part of it. I'm not really investing on crowdfunding. I think it's good. And you're seeing a little bit more. I think that you still need to have that traditional investor though, because the difference between a crowdfunding and somebody like me is that I'm going to be there when you run into trouble. I'm going to be there to help you and help grow your business. I think a percentage of a round of crowdfunding is great, but I think that the bulk of it should be from helpful early-stage investors, they're going to help you with your product, help you make introductions to potential customers, help you build your team, make introductions to other investors. That's going to be the primary goal of your seed investors. But crowdfunding is great. It's a great way to top it off. It's a great way to add 20%, 25% to your round.

Jeff: The crowdfunding investors will be there when you get in trouble, too. It's just that what they'll say to you is different than what you would say, which is to say, "What are you doing? What's happening with my money?" That's the problem. I think that's why you tend to move away from it. And just as a distinction, we're distinguishing crowdfunding where you're raising money from people and selling stock, from platforms like Kickstarter where you're actually selling something other than a security, which is a different way of raising money. And for some companies, particularly those profiting off a product of some sort, it's becoming an established way to get yourself launched, or at

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least test the market.

Jason: We have a couple minutes left. Why don't we turn to the do's and don'ts? Do have a business plan, focus on the executive summary. We heard Jere speak earlier about not getting too in the weeds on a 10-year projection with respect to monthly cash flows the next10 years. But do be prepared to talk about your company and your plan and the financing needs with investors. One thing that I spend a lot of time talking to founders about is really do understand the financing structures and terms. There's so much information out on the internet, on our QuickLaunch site, to really get founders educated as to what they're talking about when they're in the room with an investor. And, we have lawyers spend a great deal of time and they really enjoy advising companies and teaching companies about those topics, but it's really critical that founders understand that stuff like the back of their hand on their own. Jeff, do you want to handle the don'ts?

Jeff: Don't take money from anyone who offers just because they're offering or from unaccredited investors. I think what we've been talking about is making sure that you're getting investors who really understand, not only the business that you're building, but also the business of investing in early-stage companies. They understand the instruments that you're selling, they understand the risks, they understand the way that you're going to likely raise money in the future because it's really important. As Jere said, it's a 10-year relationship statistically these days in terms of how long it takes to build a business, and you want to make sure that people are comfortable from the moment that they invest, and don't make your life miserable because they didn't understand what they were investing. It's just important to find people that are a part of the investment community.

This point of don't utilize a finder to secure investments—there are securities law aspects, securities law rules associated with whether someone can be a finder to help you raise money. If you're paying them a commission to help you find that money, they must be registered broker-dealers with the Securities and Exchange Commission. And it really does make a difference if they're not because it opens you, as a company, up to exposure for violating securities laws, federal securities laws. And the problem with that is that it causes a problem for any of your future opportunities to both raise money and potentially sell the business because at the end of the day, when you raise money, and you sell people preferred stock, and you violate securities laws in doing that, what happens next is that the next investor is going to take a look at the company and say, "You know what? I'd like to give you money to invest in the business, but I see that there's a potential for you having to pay fines, and that's not something that I want to invest in so I'm not going to do it." Or a potential buyer sees that there are potential securities law violations or otherwise, and that also causes the problem in buying the business. It's all those issues that you really ought to stick to your knitting, and follow the rules, and keep in mind that what you're trying to do is build value for the long run, and cutting corners in the early stages really does have consequences.

Jason: With that, we're at the end. We've been talking with you for about an hour, and I've really enjoyed it. Jere, thank you very much for coming in and spending time with us today. And Jeff, thanks also for your time. We hope folks on the line will join us for our next session on Thursday, October 10. At that point, our colleagues are going to be talking about data privacy with an emphasis on companies that are doing business in Europe where the rules are particularly strict. You'll receive information about that topic in the coming weeks. If you have additional questions about any of the topics that we've discussed today, please feel free to reach out to any of us and we look forward to talking to as many folks as they're talking with us. Thanks very much.

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