Windom Peaks Capital, LLC

The Entrepreneurs Behind the Entrepreneurs

The Art of Raising Capital

If you want to go out and raise venture capital, stop first and think.

When you're thinking about raising outside capital, the first question you need to ask yourself is: "Is my business venture-fundable? Does it really make sense for me to go out and pound my head against the brick wall of the venture capital industry to try and raise venture capital." Because, the harsh reality is not every brilliant idea is, in fact, venture-fundable. There are a lot of really good ideas - there are even a lot of really good companies - that really should not be going after venture capital, because venture capital is a very special form of capital. It's not like all other capital. Venture capital firms require that you meet three very distinct criteria in order to justify receiving their money. The three criteria for raising venture capital are:

- The business has the potential for rapid sustainable growth
- The business is able to get to a significant size and scale in the course of that growth, i.e., it gets easier as you grow, not harder; and
- The business has the capability for ongoing disproportionate sustainable profitability

So, first of all, is it venture-fundable? Do you meet these criteria? Let's assume that you've thought about this long and hard, you've been honest with yourself, and you think through the model a little, change your business plan a little bit, and you realize, "OK, this is venture fundable" - now what? Now the question is what is the best way to go out there and raise venture capital? There are several key components to going out there and being successful raising venture capital.

1. **Starting smart** - what do we mean by "starting smart"? Well, when you start your company it's important that you put together a simple, clean company. There are a lot of things you have to do when you start up a company. You've got to rent office space, you've got to buy office furniture, etc. While these may seem important – and they may be -- there are some things that are really important that you need to get right from the start because if you don't, you'll be in trouble later on.

The first thing is, from the very beginning when you set up the company, where to incorporate the company, how to create the founder stock and who to distribute it to and in what amounts, are all issues that need to be thought through carefully. While some of this is technical stuff (which, for example, involves making sure you have the right law firm as your partner), when you set up your company, you've got to make sure you get it right; you don't want to waste a lot of cycles fiddling with it because you've done it the wrong way.

It used to be, in Silicon Valley in the good old days way back in the nineties, when companies would start up the lawyers would incorporate the company in California because, generally, companies had a lot of time before the eventual liquidity event, and, if, in the unlikely event, it happened that you were going to go public quickly, they'd simply flip your company over to a Delaware corporation at that point and then you'd go public. And that was fine. What was interesting was that during the bubble, the investors and the law firms realized, "Well, we've only got nine months between incorporation and going public so we might as well start in Delaware!" So, increasingly, what you'll see is the venture law firms are starting companies out in Delaware. However, even if you start in your native state to save early expenses, you don't want to start out as an S corporation or an LLC and start approaching venture capitalists saying, "Don't worry - when the time comes, we'll create the right corporate structure." Just do it right the first time, set up the right corporation - probably it's Delaware, maybe it's California, I don't know where you're from - if you're from California, probably it's California, it's probably not Florida.

Then you have the process of distributing founder stock. It's amazing how many people get into trouble here - so you need someone who's done this before and who understands technically what this all means. While it's not appropriate to go into all of the technical details here, just one comment about one key mistake people seem to make over and over again. You see a lot of entrepreneurs very early on in the process making promises to their co-founders about how much of the company they're going to get. And you have this discussion about, "Okay - we'll each take thirty-three percent of the company!" Well, thirty-three percent of the company when, and on what basis? It's a very ambiguous kind of phrase - don't ever get into that discussion with your founders. The next thing you know, you bring on another guy and they get another ten percent, then you bring on advisors and they get two percent, and then there's this great board member and they get another four percent. Whatever the numbers are - you get into trouble if you start promising percentages of the company.

At the very beginning, put together a plan for capitalizing the company over the long term, and make sure you understand how each of the founders is going to fit in to that. Distribute the founder stock very carefully and precisely with real documentation. And then the other piece of it is you've got to sign buyback agreements as founders. And every entrepreneur when they're before VCs for the first time, they usually walk into the VC's office -- they're already in multiple layers of discussions -- and the VC says, "Now, you guys have all signed buyback agreements, right?" And the entrepreneurs look at each other and say, "Well no - we've been working on this for five years. We've worked long and hard on this in our garage, and we own that stock!" And the VC says, "Well, you know, you don't really." And then you have this discussion, and it's usually bloody and it's messy. Get it into your head that it's the right thing to do, to have a buyback agreement among the partners who start the company. Many times companies have blown up after six months or nine months after funding - one of the partners leaves, one of the founders leaves, you know the founder's wife ends up having half the stock, whatever it is. Put together buyback agreements so you don't get all messed up as things evolve over time with the company.

And then - as you start bringing employees into the company, and you bring in consultants, and you bring in advisors - do it clean, do it right, do it with documentation. Get your law firm to give you standard employee agreements, standard consulting agreements, standard advisor agreements, don't promise percentages of companies. If you're going to distribute stock, do it very carefully and precisely. Be sure that everybody that is working for you is developing intellectual property that the company owns.

And that gets to the next point: make sure you manage your intellectual property. When you talk about "intellectual property", people generally think "patents", and they think, "OK, it's off in this domain of going and filing patents." But it's not just about patents. It's about making sure everybody who works in the company has signed appropriate agreements. It's about making sure that all the know-how is appropriately protected or licensed, about making sure you're not stealing something from your prior company. It's about making sure that the company owns the intellectual property and it's appropriately protected. And then when it comes time to take money from some seed investors, make sure you do it, again, the right way - from smart investors who now what they're getting into. Don't take money from Aunt Martha if Aunt Martha's going to give you a lot of trouble - now I used to say "unless your Aunt Martha is Martha Stewart." However, now I say especially don't take money from Aunt Martha.

But there's a process of taking seed capital using convertible notes, using the right instruments, bringing the right qualified investors into the process - you want to pay good attention to that. And you'll do that, as we've said, in a convertible note or loan rather than trying to sell Series A preferred stock to your Uncle Fred.

Lastly, when someone says, "Well, you know, startup companies shouldn't really have to worry about Sarbanes-Oxley and that sort of thing." Don't believe it for a second! In this environment right now, a lot more attention needs to be spent on proper governance from Day One. And that means things like all the things mentioned above - it means things like thinking through compensation structures, thinking through option policies, thinking through/making sure that you don't have any funny deals within the founders, and the investors, and the board members, or the customers, or anything like that. At the very beginning, don't assume that what you're doing is private - assume the things that you are doing, relationships you're building, will become public at some level, and you want to make you they can survive the light of day. So pay attention to governance from day one. Be professional about the way you set up your company, and how you start your company, from Day One.

2. **<u>Tell a good story</u>**. If only every entrepreneur had spent a little bit of time listening to Guy Kawasaki the world would be a much better place. For those of us who are at the other end, you know, receiving it, you know, the sky would be bluer, the birds would sing sweeter, if only entrepreneurs had taken to heart the lessons of how to articulate the fundamentals of their businesses.

As you approach the venture capital community, you have to understand what's going on in their heads - inside the heads of an investor there's generally a scorecard that they've developed over the years. They're scoring you - every communication you've got - if it's an email, if it's a phone call, if it's an in-person presentation - they're scoring you against these different factors and evaluating your business and how well you understand the fundamentals of your business. Those scorecards vary, you know, from investor to investor -- different investors have different biases as to what's the most important -- but it's usually some combination of these six elements:

- the team and how good (or bad) it is;
- the problem that you're going after and how big the opportunity is;
- the technology and solution you're putting together;
- the sustainable advantage that you've got;
- what sort of business model you've put together, is it proven; and
- How do you leverage this business with partnerships.

The main point here is: it's not just about getting someone to put together a great pitch for you; it's about having the whole team understand the fundamentals of the business and being able to articulate any one of these in any given communication you've got.

If you're the CEO of a software product of service, this means that while you don't necessarily have to be able to recapitulate the code that it's written in, nevertheless, you'd better be able to articulate each of these elements and the fundamentals of your business in any given context. It's also important to understand that different investors are going to focus on different elements. You've got to listen to what they're worried about and make sure you can address the concerns that they're most focused on and be articulate about that issue.

3. **<u>Make sure the numbers add up</u>**. Make sure that you can demonstrate a fundamental understanding of the economics of your business. Now, some entrepreneurs are more analytical from a financial perspective than others. There are a lot of CEOs that position themselves as, "I'm the big picture guy - talk to my CFO when it comes to numbers." That's not good enough. If the VC is entrusting you with millions of dollars, then he or she wants to know that you understand at a very fundamental level what business is all about. Business is about economics, and that means that it is about numbers; it's about the way you make money. You've got to understand the numbers of making money if you're going to run a successful business.

So, let's talk about some of the numbers that you've got to focus on. First of all, there are the long-term financial projections, which, despite what you've told, are actually really very important. VCs get a lot of entrepreneurs that push back on them and they say, "You know, why should I do financial projections for this business? I have no idea what the world's going to look like in five years! And if I pull it together, everybody's going to know I'm just making it up!" And, typically, the VCs response is "Why should I invest in a company where you're just making it up? Don't you have some sort of vision of how the future is going to look? Don't you have a way of understand how the economics of your business might play out?" While the VC won't believe any long-term financials as being accurate, nevertheless every set of long-term financials should tell a story. It should tell a story that maps to a vision of the way the future's going to unwind. So your long-term financials are not a spreadsheet exercise that you give to some consultant who knows how to use Excel. Your long-term financials are a way you tell the story of your business using numbers. And they're driven by the underlying metrics that drive your business. They're not driven by cell formulas - they're driven by how are you going to go get customers? What are you going to spend to go get those customers? What are those customers going to pay you? Some of the points discussed above will help you tell the story using numbers, will help you present a vision of the future that makes sense in your long-term financials. And test them with comparables - go find other successful companies that you want to model against and say, "Has any company in the history of the world ever performed the way I'm projecting my company will perform?" Almost always, every set of long-term financials VCs see outperforms the most successful companies in the history of business. So, get a little reality in there. Go back, look at great companies and say, "Hey, you know, this is what I will look like if I'm a great company" - test you assumptions there.

The other side of this spectrum is the near-term operating plan, and most entrepreneurs see that as the first twelve months of the long-term plan. It's embedded in the same spreadsheet. Probably that's not a good way of doing it, because one way or another, either you're going to get too high-level and not have a good near-term operating plan because it's driven off the long-term financials, or you're going to spend too much time figuring out how many paperclips you've got to buy in year five if you use your operating plan as the same tool.

So, tactically speaking, when you are developing a near-term operating plan, understand that it has a different role than the long-term plan. The long-term plan tells the story, the near-term plan says, "OK, what are my levers and what are my variables in the very near-term as I'm raising capital. Can I adjust quickly to rapid changes in the outlook? If things slip, do I hit a brick wall or do I have a way of escaping if things don't play out quite the way that I'm hoping they will?" That's the way a VC looks at the near-term operating plan - they want to see that you have the ability to adjust quickly and react to changes in the environment. And they want to know that you're going to use their capital efficiently during that initial period of time and that you've got the runway to get to the next large milestones in your business. That then enables them to understand your capital requirements, not just for this next round of financing, because you'd better understand your requirements over multiple rounds of financing and be able to model out what the capital structure of your company is going to look like from here all the way out to an acquisition or an IPO, or whatever other liquidity event occurs. On this point, a lot of entrepreneurs take the attitude, "Well I don't really know; I'll probably go raise some more money at some point in the future." But if you don't do the work of thinking that through, then it's going to fall back on the investor to think through what sort of capital you're going to require, because investors need to understand how the company is going to look over multiple rounds of investing. So you are encouraged to do the work of building the model for the way your company's going to change with different levels of capitalization.

For example, in your Series A round, you'll be selling thirty-five, forty, fifty, sometimes even more percentage points of you company. And then you've got a Series B, and maybe even a Series C - God help you if you have to have a Series D! But over time, the way the Series A investors look on your cap table changes pretty dramatically, depending on how things work out. That's really important to a Series A investor. So, do the work of understanding how much capital you need and how your capital structure's going to change over time.

And then finally, make sure you can articulate clearly what the sensitivity points are in your financial model - what are the key metrics and variables that you're going to be watching like a hawk - that demonstrate whether or not you model is valid, or whether your model needs adjusting. You should have a dashboard of key metrics - that aren't necessarily financial metrics. You know, it's things like: how many days does it take to close a sale, what's the cost of a typical customer acquisition, what's the value of a customer once you acquire them, how long does it take to get from point A to point B in any given customer relationship, when will they buy up, how many customers are converting from the initial product to the advanced product, how many customers are re-upping in a subscription model. You've all these metrics that are the most significant variables in your financial model. You better be able to articulate those very clearly, you better be able to show how they drive your long term financial success, and you better be able to show how you are monitoring them over time. So, make sure you get the numbers right. Put all this together and only then, maybe, it's time to go out and find the right investors.

4. **<u>Generate some momentum</u>**. The reality in the venture market right now -- probably the single most important thing you have to do before you go after venture capital -- is that you have to generate some form of momentum in your business. It is no longer the case, if it ever really was the case, that you could sit down with an investor and a napkin, and talk about a brilliant idea and raise capital. Now, maybe that will happen again in the future at some point, but don't count on it - it isn't a plan for raising capital. What you have to do first is show you've got some sort of momentum.

Now you say, "But I have no money! How can have momentum without any money?" Well, a lot of other people have figured out how to do it. There a lot of ways you can make progress in the development of your technology, in the development of possible customers, in the building of your team, in getting some sort of alpha or beta or something out there to validate your marketplace before you even have money. You've got to figure out how to do that so that when you approach investors you can say, "Here's what we've done with nothing - imagine what we can do with your capital. I'll help you imagine - here's the forecast for this business."

5. **<u>Target the right investors</u>**. You've got to make sure when you're going after the venture community that you're spending your time wisely targeting the investors that make sense for your business, for two reasons. One: if you go to the wrong partner at the right firm, you may have shot your chance at that particular firm. So, it's not just about figuring out which venture capital firm to go after; you've got to go the extra distance in your due diligence and figure out who's the right partner at that firm. Now, for most entrepreneurs, the process looks something like a variation on one of two themes. The first one is: they go around to their friends and they go around to their ecosystem buddies and they say, "Who do you know in the venture community?" and they compile a list of all the people their people know and they assume that list of "who do you know" is the right community to target.

But that's not right. You've got to drill into the next level and find out which of these people are the right people. If not them, is it one of their partners, or is their firm even relevant? Is it a life science firm and you're an IT kind of company - you won't believe how many times that happens, or vice-versa, an IT firm with a life science deal.

The second approach is that the entrepreneur finds the directories, a directory of venture capitalists, and gets as many email addresses as he or she can and then blasts the model out. Now, the great thing about the venture community that has changed over the last five years is nobody uses FedEx anymore - so that's a good thing; it saves entrepreneurs a ton of money. But it's also a really bad thing, because it seems like it costs less to send an additional business plan to an additional person. But there is a cost, again, if you send your plan to the wrong person; you're going to develop a negative reputation, perhaps, in that firm.

Do your homework, figure out who the right investors are, and then, once you've figured out, "OK, this person at this firm is the person I want to get to" then go back to your ecosystem and say, "Who knows this person? Who has a credible introduction to this person? Who can help me get a credible entre to this individual?" And you try to build as many links into that person before you go out to them. And then you personalize your communications with them, none of this "to whom it may concern" or "dear sir", which is just great if you're targeting a woman. You personalize communications, you say, "Hey, I noticed that you've invested in this space, you invested in this company, we think our company is complimentary, we think that our company is the next generation" - show that you've done your homework, show that you understand the space that investor invests in, spend the time to do the homework, and then target at a more limited number of venture capitalists, rather than playing the percentage game: "Gee, if I send the plan to two hundred investors, all I need is two percent of them and I can get my company funded!" It just doesn't work that way.

6. **<u>Nurture a syndicate of investors</u>**. Assuming you get some venture capitalists interested, you still need to nurture more than one. You've got to nurture a syndicate of investors. A syndicate of investors is always headed with a lead investor, so the first thing you have to do is find lead investors: guys or gals who will write the term sheet to invest in your round. And then help build the syndicate around that lead investor.

The syndicate is a group of other investors who, for whatever reason, would prefer not to lead - they're a smaller fund or they don't have the time to take a board position and but they want to co-invest in the space - you have to build a syndicate. Now there are a lot of fairly straightforward, common sense rules about this. You want to be careful when you're building this syndicate that you don't go out and say, "Hey! I've got XYZ, top-tier, Sand Hill Road VC, that's going to be giving me a term sheet any week now! Wouldn't you be interested in joining them in this deal?" Well, if you don't have that term sheet, then you're going to get in a lot of trouble when the new prospect calls this person and discovers, "Well, yeah, I had a meeting with them. But that doesn't mean I'm writing them a term sheet!" You've destroyed your credibility and, in the process, you've lost two potential investors. So be very careful about how you cultivate your syndicate and you bring them together. What you want to do is get the lead investor to step up to the table, to commit the funding, and to help you build the syndicate.

If you can have two syndicates competing, that's even better. That's a hard thing to accomplish, however. Ideally though, you want to get one or two investors who are working with you to build the syndicate. However, do not abdicate the responsibility for building the syndicate to the investor; you've got to be part of that process, the process to build the syndicate.

7. **<u>Understand that the process of raising capital is the process of selling</u>**. Throughout the whole thing understand the process of raising capital is a selling process. It's stunning to discover that even sales and marketing oriented CEOs, for whatever reason, when they get into the venture process, they often lose their way. They lose sight of the fact that this is just another complex selling process, and it requires all of the steps that any selling process requires: you've got to qualify your leads; you've got to make sure that the person you're talking to is the right person to talk to; you've got to continuously do trial closings; you've got to figure out techniques to move the process forward - "OK, so great! When's our next meeting? Can we do next Wednesday at noon?" You know, "If I get you this information, will you be ready to give me a term sheet?" All of the standard techniques of selling: "Who else do I have to talk to? When do I get to talk to the rest of your partners? What's it going to take for you to write a term sheet? How much of the round are you interested in?"

Just standard selling techniques. It also includes being persistent. Amazingly, you get these incredibly scrappy, aggressive entrepreneurs - but when it comes to talking to VCs they kind of feel, "Well, I'll let them drive the process." You know, "Have you talked to this firm recently?" - "Well, no. He said he was going to get back to me…" "But why don't you call them back?" There is a very fine line between persistence and stalking. But you've got to push that line. You've got to push that line and, worst case, they say 'no' - that's fine! You can focus your energies elsewhere. It's better to get to a fast 'no' than a long, drawn out 'maybe' that eventually ends in a 'no'. So, manage this just like a selling process, because that's what it is!

8. **<u>Build credibility</u>**. The next point, which is kind of nuanced, but so fundamentally important -- and it's amazing how many times entrepreneurs blow it on

this point -- you've got to build your credibility. There are a lot of factors that enhance and detract from your credibility during this process. Let's run through a few:

- **Customers**: If you have customers who are referenceable, that's wonderful. So go - perhaps the best way to go get venture money is to get customers first, customers who say they've bought what you have, and they want more of it, and they love you. Not everybody can do it, but it's a great credibility builder.
- **Strategic Partners**: Short of customers, there are strategic partners - now that doesn't mean you have the Software Development Kit from Microsoft and they're a strategic partner - it means you've got a referenceable relationship with a company that really wants to help you succeed.
- **Credible investors, advisors or board members**: Some earlier seed-stage ventures have been able to attract some seed investors who are credible world-class investors. If not world-class investors, how about world-class advisors or board members? They'll do in a pinch.
- **Industry experts**: Are there industry experts out there who you've met with, analysts who you've talked to, who will vouch for the fact that this is an important new breakthrough, smart industry gurus who can sign up to say, "Look, what these guys are doing is the next generation".
- **Hitting milestones**: Are you hitting your milestones? One of the things that happens all the time is entrepreneurs, in their first meeting, say, "By next week I'm going to sign this deal with XYZ person" and a month later they have their second meeting with the VC and the VC says, "How's that deal going?" "Well, we're still negotiating it; we haven't signed it up yet".
- **Don't lie!:** And last, don't lie. Seems kind of obvious, but how many times do we see entrepreneurs who are basically lying during the process. Now, there are lies and there are lies, and, you know, obviously we've seen in the news lots of stories of really bad lies. But there are also some subtle lies that you hear all the time, and so, there's so many of them in fact, we've had to compile a list.

Typical lies -- There are a lot of things that entrepreneurs say during the process of raising capital that just demolishes their credibility. So, here goes:

<u>The Top Ten List of Lies That Entrepreneurs Say Most Frequently.</u>

Lie #10: ***Our projections are conservative***. Now, most people don't think that's a lie, but it is. It is - your projections aren't conservative, you know they're not conservative, you know you're going to miss those projections, just stop using the phrase "our projections are conservative".

Lie #9: ***Our target market is $56 billion***. You know, you may be able to add up all the economic activity in every sector in which you're possibly going to do business, but that has nothing to do with your target market. This destroys your credibility when you say this.

Lie #8: ***We have a world-class team***. Now, we know you're proud of your team, We're sure you have a great group of talent on your team, but it probably isn't world-class unless, maybe - is Jim Clarke part of it? You may have a great team, but don't tell us it's a world-class team because it probably isn't. They may be smarter than anyone else in the world on a specific topic - tell us that, and let us know why that is.

Lie #7: ***Our average sales cycle is 90 days***. Well, while your first customer who ever bought your product only took ninety days from the time you started to the time you ended, understand that, nevertheless, that is not going to be your average. It simply is not your average – rather, that is at the far end of the bell curve. The average is what happens over the long end - you have not yet sold all the guys you haven't sold yet. The average is going to be much longer. Lots of entrepreneurs get trapped because they build into their model this ninety day sales cycle, when in fact it's nine months. Or twelve months. Or longer. Be realistic about your sales cycle.

Lie #6 - ***We have no direct competition***. Almost certainly, you have competition and if you think you have no direct competition it's because you haven't done the work to find them, or because you're lying to us. Either way, we're not that excited about the work you haven't done.

Lie #5: ***No one else can do what we do.*** Well, you may be the first team to produce this particular prototype of this particular technology, but everybody knows that with enough resources and talent other people can do it, too. This is not a compelling competitive advantage. What we want to know is why your competitive advantage is sustainable. Why it is that because you have these three people on your team that your team will be able to sustain your technological advantage over multiple product cycles - that's a competitive advantage, not the fact that you've tinkered together a technology that no one else has bothered to build yet.

Lie #4: ***All we need is 2% of the market***. We want to target the company that wants to go after the 98% that you're going to skip. That's the company we want.

Lie #3: ***We'll be cash-flow positive in twelve months***. You know, God bless. From your lips to God's ears - but it isn't going to happen.

Lie #2: ***Our contract with Nokia is going to be signed next week***. Well, don't start talking about when that contract is going to be signed until after it is signed. You can talk about conversations you're having with Nokia (if that's OK with Nokia), you might even be able to get a referenceable relationship discussion. But don't promise contract signature dates until after they're done. Under promise, over deliver. Surprise investors with momentum. Don't miss milestones and destroy your credibility; and last…..

Lie #1 is: ***I'll be happy turn over the reins to a new CEO***. You know, as many venture capitalists like to say, there's a big difference between the CEO and the entrepreneur you're talking to. Does the person you're talking to truly understand the process, i.e., that they're good at the early stage and they want to bring someone else in the later stage. On the other hand, there are those entrepreneurs whose fingers you have to pry off the steering wheels with a crowbar. It's OK, some entrepreneurs can make that transition, others can't and shouldn't, and know that they shouldn't. And there's a big difference between the two.

In summary

So, in summary: What's the best way to raise venture capital? Again, answer the first question - make sure you understand that your business is, in fact, venture fundable. Then, if it is, make sure you set it up the right way. Articulate the fundamentals, both in prose and then in numbers -- understand the economics -- and make sure your financials tell the story of your company. Understand that raising venture capital is a selling process and use your best selling techniques through the process and then throughout the process build your credibility. So, that's the best way to raise venture capital. The fact of the matter is: not every company will be able to succeed at the end. However, if you follow all of the above, and your company is truly venture-financiable, you'll have a better than even shot at getting what you need and want.

Good luck!