



# Top 10 Secrets Every Founder Should Know

A Forward Innovations White Paper



forwardinnovations



## Founders' Secrets

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Guy Kawasaki calls it the “Art of the Start” and founding a company is clearly an art. It is an art because you are playing a very significant game, with tightly defined rules, and the penalty for breaking the rules is death (of the company, that is). The problem is, no one gives you the rules. You are expected to understand a game that is neither intuitive nor obvious. In fact, the game is quite complex and often based on a set of traditions that were never written down. Founders must make extremely critical business decisions every day that could literally be worth 10s of millions of dollars in 2-3 years. Although it is unfair, it is the game and if you win the game you win a lot.

So why don't your company advisors help you navigate this game? To a certain extent they do. Your Angel investors, attorneys, accountants, and venture capital partners all help you navigate, but they do the navigation from a certain context and bias that is not always in alignment with you as the Founder. Your attorney probably provides the most advice in these situations, but it can often be very slanted. If you go to any of the top startup law firms, these guys very much understand both the game and the ramifications of the game. But there is also a bias at play here. If you are negotiating with a top VC, you are doing one deal with this law firm, but the firm is probably doing 50-100 deals a year with the VC on the other side of the table.

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So who is in the best position to help you? They don't teach this stuff at Harvard, you can't learn it by being on a Board, and people that have not founded a company can simply not understand it. The only mentors that can help you play the game






and understand it from your perspective is a serial entrepreneur. Serial entrepreneurs know where the tricks and traps are, not because they are super smart, but because they probably have stepped on them and seen their critical ramifications. They may not be smart enough to not experience the pain once, but they quickly put a strategy in place to not experience it again. By looking back in time against a game that has already played out, they can see how the game can be played better. This white paper was specifically written to give you some insight and perspective on how you can play this game and not get burned. Although it does not lay out all of the rules, all of the tricks, and all of the pain, it puts “bumpers on the bowling alley” and tries to keep the ball in the center.

➤ **Founding Team the “Hustler and the Hacker”**

For years, there was a gut feeling that having two Founders was the right mix. It was proven by Bill Gates and Paul Allen, Steve Jobs and Steve Wozniak, Jerry Yang and Dave Filo, Larry Page and Sergey Brin. But in 2011, the Startup Genome (a comprehensive study done at Berkeley) came out and it showed that there was a 65% greater chance of success if there were two Founders.

The best mix is what is called the “Hustler and the Hacker”. The Hustler is the passionate business person that loves to go out and tell the story. He is a networker, and when he talks, he is captivating. He spends every waking moment thinking about the problem, and he wants to change the world. He is eloquent, confident, and mesmerizing. The Hacker is the guy who spends 18 hours a day building the product and delivering on that vision. He is thinking about scalability, availability, reliability, and how they can incorporate the next cool technology into the platform. There is great respect and great trust in this partnership.

This mix used to be a “nice to have”, but since the Genome report, it is nearly a “must have”. The best way to solve the problem is just make sure that you have this mix and make sure you push it in your pitch. Stress the role each of you play and stress your great connection. If you do not have this mix, you should be very prepared to defend why you



don't. Many Angels are now considering this mandatory and a business guy and a contract India team are no longer sufficient.

> **Capitalizing the Company**


This is one that for some reason a lot of attorneys screw up. I don't know why, but they do. If you are setting yourself up for an Angel, Venture, then IPO style company, it needs to be done this way. You need to be a Delaware C Corporation, with around 15M shares of common and 5M preferred authorized and then 4-6M shares (depending on the F/FF stock) issued to the Founders.

Probably 90% of the companies that Forward Innovations works with come to us with this done incorrectly. They will be set up as a California LLC with a 1,000 shares. If you want to have an option program and you want to sell preferred stock, you cannot be an LLC. I know - your attorney told you that California or Nevada or whatever state has adopted the Delaware statutes and they have the same laws as Delaware. Yes, but all of the case law is in Delaware and that is imperative in a lawsuit. All VCs and most smart Angels will want you set up this way.

Why all the stock? You want the company to be in a position that when you have completed Series A investment and you bring on the "big guns" of the executive team, you have about 10M shares issued. This allows you to go out recruiting with about 200K-300K shares for these executive. I know that 20 shares of a company that has 1,000 shares issued is the same percentage as 200K is to a company with 10M issued, but it doesn't sound the same. It won't sound the same to the executive you are trying to recruit, and it won't sound the same to their spouse.

> **Founder Protection**

In the last 5 years, many very seasoned Founders have been demanding either F or FF Stock. F Stock has Protective Provisions that prevent investors and other shareholders from playing dirty tricks. Usually



they require that the Founder approve anyone of the following transactions: authorization of new stock, issuance of stock, change in the make-up of the board, an IPO, or an acquisition. These are the same Protective Provisions that the investor will have, and you want them for the same exact reason. It will help you negotiate these if you purchase the stock at a higher value than Common, but you can negotiate them either way. If you saw the movie the Social Network, this would have prevented the game they played on Eduardo at the end of the movie that took him from 1/3 of the company to 1/3 of a percent.

FF Stock has all the Protective Provisions of F Stock, but also allows the Founder to receive some liquidity at each round under specific conditions. FF Stock was

designed by Peter Thiel and Sean Parker at the Founder's Fund, hence the name FF Stock. FF Stock can be converted and sold at any round under certain conditions, usually as long as there is Board approval, an oversubscription on the round, and you are selling less than 15% of your total stock. It used to be that a Founder getting liquid early was a very bad thing. But with the average exit now at 12 years and the fact that Founders often put themselves at tremendous financial risk, this has become acceptable to many investors. Also, by having a separate class that you can sell, this will not trigger the 409a laws and can even be used as a blocking strategy to help you lower the price of the Common Stock.

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## > **Friends and Family Round**

Usually the first investment round you will do is the Friends and Family round. This is typically a small round, \$50-\$100K, and usually done as convertible debt. The objective of the round is to get enough put together that you can raise your Angel Round. To complete this round, you will usually need to put together an engaging Executive Summary and 4-5 mockups of what the product will look like in the future.


Since the investors of the Friend and Family know you, much of their investment decision will be based on you and their belief that you can execute. They are often unsophisticated investors, so go to extra efforts to make sure they understand the deal and the strategy of the business.

Friends and Family rounds are usually done as convertible debt, which will convert into the Angel Round. It will usually have some advantage on the investment, such as a discount or warrant coverage. A good way to do warrant coverage is to give 10% upfront and the 1% for each month before they are converted.

Because the Friends and Family round is small and the investors are often unsophisticated, you can structure the deal so that their money comes back to them on closing the round. They get the interest on their money and their return is the warrant coverage. Angels used to never let you do this, but now most have seen that it is a lot easier to manage only larger, more sophisticated investors. This is especially true if you have a hot deal and you are able to get an oversubscription. This makes a nice return for your important family member, and makes your life a lot better at Thanksgiving.

## > **You Can't Make an Angel Rich**

One of the key things about Angel investors is that you cannot make them rich. They are already rich; that is why they are angel investors. In fact, very little of their decision to invest in your venture will be



because you have promised them this amazing return. Since the first round used to always be done by venture capital, many Founders make the mistake that Angel investors invest just like venture capital investors. They are not only different, they are almost opposite.

Although Angels do make a very logical decision when they invest in a round, it is not their first decision. To engage an Angel investor, you must engage him emotionally. He wants something that is exciting, clearly disruptive, and something that will be great to tell his friends about. If other great investors are involved, that is even better. If his expertise and contacts are influential to the business, better still. If you can connect with the Angel on this emotional level, he will be ready to go to the next decision point.

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The second decision is also not a logical decision, it is relational. The Angel wants to know that he will like working with you and that you are trustworthy, reliable, and coachable. He will probably need to work with you longer than either of you expect, so he wants to make sure the relationship can survive the stress.

Finally, the Angel does make the logical decision. The good news is that most Angels are ex-founders themselves, so their logic *is* usually logical. This is not always true with venture capitalist. The Angel understands that at this point in your lifecycle, you will still have a lot of holes. He is not expecting you to not have any problems, he just wants to make sure you have a good plan on how to solve them. He wants your plan to be thoughtful, realistic, and well designed. It is very important with the





Angels that you are well versed in the trends of the time, i.e. lean startups, MVP, Agile development, business canvas, etc. They are typically very current on these trends and will often expect to see them at play in your strategy.

So the Angel does make a logical decision, but it is after making the emotional decision and the relational decision. You have to design your pitch around this concept and make sure you connect with him here first. If you jump straight to the logical decision, you will probably not get him to engage and not get his investment.

➤ **Angels, AngelList, Accelerators, and Angel Groups**


Never before has there been a better time for entrepreneurs to start a company. Not only is there more Angel money than ever before, but the methodologies, resources, mentors, and just new information are at an all-time high.

As the Dot.Com era finished, everyone remembers the “bust”, but in reality, in 1997-1999, more money was made than any time in history. Executives from Yahoo!, eBay, Ariba, CommerceOne, and hundreds of other left the high with millions of dollars. In the early 2000s Google, PayPal, and Skype added to the fray. Recently, Facebook, Twitter, and Zynga. The tech market is now full of very wealthy Entrepreneur/Angels that not only have enormous sums of cash, but incredibly valuable experience. They are playing the game and they are playing it well.

Some of the Angels are doing so well that a moniker was created, the “Super Angel”. Top Super Angels like Ron Conway, Andy Bechtolsheim, Ram Charan, and David McClure are hitting it out of the park and making returns that would embarrass the VC community. They are not only playing it well, they are playing it very smart.

As the Angels community began to increase in size, the founders of Venture Hacks came up with the great idea to organize them into an





online community. In 2010, Nivi and Naval, launched AngelList, and it has been a roaring success. In less than one year, AngelList and helped over 800 companies get financing and today the list contains the “who’s who” of the Angel community. AngelList is a great way for companies to quickly get in front of more Angels that are really investing.

The number of Angel Groups has also multiplied enormously. Virtually every major city has several Angel Groups. Many of these have you present at a monthly event, and then the organization completes a group due diligence process. These groups serve an important part of the ecosystem and have brought into the investment circle a lot of investors that normally would not play the tech market.

All in all, this market is at an all-time high, for both access to money and access to information. The transparency between the investor and the entrepreneur has greatly increased and the metrics of what makes a startup work are being established in detailed. This is a good market and it is good for both sides of the table.

> **The Series Seed Round**

The lawyers have also got in on the party, and several of them are now really adding a lot of value. Several top lawyers are now blogging and providing detailed articles on the ins and outs of an Angel round. There are several blogs that have “dissected” the term sheet and literally walked through every term - explaining why it is there, what you can negotiate, and what the ramifications are if you leave the term in place. They are also explaining the Restricted Stock agreements, Employee agreements, the Stock Option program, and how the capitalization of the company works.

Several lawyers have now created a database of “Open Source” legal documents. This includes many of the documents mentioned above, but probably the most important set is called the Series Seed Investment Documents ([www.seriesseed.com](http://www.seriesseed.com)). These documents were created by Fenwick and West, and they have been a great value to the




entrepreneur community. The legal documents for an investment often cost between \$15K and \$25K. This is bad enough if you are doing a \$3M-\$5M Series A investment with a VC, but it just does not make sense with a \$1M round with a group of Angels. The Series Seed documents solve this problem. They are a very simple set of documents that protect both the entrepreneur and the investor. They are based on straight preferred stock with no preference, weighted average anti-dilution, and normal information rights. They greatly simplify the process and make it very easy for everyone to just say these docs are standard, let's leave them the way they are. Using these documents, you can usually do a seed investment round for around \$3K. That is a great deal for everyone. Even the lawyer does well, because if he uses these documents he will usually be seen as a long-term friend of the company.

➤ **How Do You Set the Valuation?**

Although setting the valuation is often seen as a point of contention, the parameters for this argument are being put in place. First, as a founder, there are several places you can turn for comparables. Adeo Ressie created the popular site “The Funded” and Founders post their term sheets on the site for others to review. The Startup Genome provides important milestones for a company to achieve and the valuation established for achieving them. Finally, it is easy to watch AngelList, Crunchbase, and Alltop Startup for the deals getting complete and the valuations being given.

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In general, an Angel round of investment will get somewhere between a




\$3M and \$6M pre-money valuation, when raising \$1M-\$1.5M in capital. Most investors will see the valuation divided between 3 important attributes. The first, and probably most important, is the team. As described above, most investors are looking for a team with a hustler and a hacker. An experienced team that has worked together is given a higher valuation. A team that has experienced an exit will get even higher. A top team will provide about \$2M towards the \$6M valuation.

Next is the product. By the time the Angel round is being conducted, the team should have produced a “minimally viable product” and expanded it with several iterations to about a Release 0.5. Focus should have been set around developing defendable IP, and the core architecture should begin to be put in place. If the product is in this state, it should secure another \$2M towards the \$6M valuation.

Finally, the Angels will look for customer traction and validation. Depending on the product segment, this could be a small and growing set of users or a large design partner. It is expected that you have real customers at this point and speculation will usually not suffice. The customers should be active, engaged, and most important, satisfied. It is not important for the customers to pay, but it is important that they are engaged. A customer base like this will fill the final \$2M towards the \$6M valuation. If you score at the top of each of these attributes, you should be able to negotiate the full \$6M valuation. If not, the valuation will be discounted. If the valuation provided is below \$4M, you should probably reconsider your timing and get some of these requirements in place.

> **Orchestrating the Round**

One of the key items missed by new founders is that the raising an Angel round must be orchestrated. Mark Suster, of GRP Ventures, says it this way he “likes to invest in lines, not dots”. What he means is that he wants to develop a relationship with the founder before he is asked to make an investment. The orchestration of the Angel round should



include getting to know the investors, understanding their perspective on investing, developing credibility and trust, and a soft close.


It is always best if you are referred to an Angel by someone who is known and trusted by the Angel. If you meet the investor outside of a referral, a good way to get to the same place is to search Linked-In and see if you have any contacts in common. The objective is to quickly set the relationship into a context of “this is a good guy and he is doing something important”.

Next, you need to understand the investor and why he invests. There is a saying that goes, “If you ask an investor for money, he will give you advice. If you ask an investor for advice, he will give you money.” You want to know whether the investor likes your deal because it is in a space he has interest and expertise, you have an investor that he likes to invest with, or if this is a problems that he has himself. It is rarely a financial decision early in the relationship, so fish for the real reason.

*“I like to invest in lines, not dots”*  
Mark Suster, GRP Ventures

Then, over a period of a few weeks, tell the investor that you are going to do several things with the business and make sure they are done on time. You want to create the pattern of “I said I was going to do this and I did it”. Customer milestones like “I am going to be at 100 users by the end of the month” or product milestones like “we are going to ship the MVP on the 30<sup>th</sup>” are great examples. Don’t mess up the easy ones like “I will send you an Executive Summary tomorrow” or “I am going to call you early next week”. Make several commitments and then make sure you execute.

All the time you do the above, it should be in the context of “we are not raising money right now.” A good way to set it up is to say, “...but we have a big customer opportunity in 30 days and if we close it, we are



going to do a quick round.” Build up the demand behind an important milestone like a customer win, a product release, or a key hire. You want to soft circle 1.5 times the amount of money you are going to raise, before you start the raise. A good way to do this is that every time you talk with an investor, steer the conversation first to, “What investors do you know that would be interested in a deal like this?”. Not only does this get you more investors, it increases the chances of getting the one you are presenting.

Once you have a critical mass of investors, start the investment process. When you reach the business milestone, tell everyone that you did and how important it is to the business. Then say you are opening the round for 10-15 days and then you have to get back to work because you now have to deliver on the milestone. This is especially effective if the milestone was a customer sale and you have to deliver the product to the customer.

Lock the time period so that the decisions are made quickly. Time is not your friend in these situations and “rolling closes” rarely close.

Once you have closed, send every one of your investors a personal thank you for their investment. Tell them how much you appreciate what they are bringing to the table, other than money, and tell them how you are going to communicate with them and keep them engaged. You would be surprised at how many founders take 300-400K in investment from an Angel and never thank them for it. Don’t make that mistake. Your most likely next investor is the investor you already have. Make sure you keep him happy and excited.

> **The 20/200 Decision**

One of the key decisions you will need to make as the Founder is whether your company is a \$20 million or a \$200 million exit. I know we all want that \$200M exit, but the reality is that 95% of all exits are below \$20M and 97% are below \$30M. Only 1% is above \$100M and



pretty much the whole venture industry is chasing that 1%.


But, if you play it right, as a founder you can make a lot of money on a \$20M-\$30M exit, and they are a lot easier to obtain. In fact, founders often make more in a \$30M exit than they do in a \$100M and the risk to them is far greater.

In a \$20M exit, a company has probably taken in \$3M-\$4M in capital and they are probably 2-3 years old. If done right, the investors should have about 40% of the company or \$8M. That means the founders and the employees are splitting \$10M-\$12M. In this scenario, everyone has a big party.

In a \$100M exit, there have probably been at least 2 more rounds and the VCs own close to 75% of the company. The company will probably be 5-7 years old. If all goes well, and it probably won't, the VCs are taking home \$75M and the founders and a much larger group of employees are taking home the remaining \$25M.

But if there is one slip up and you misshape a round, not only are you not going to make as much as the first scenario, but will have probably been replaced with a "professional CEO" and often you get only the scraps left over on the round. There are just way too many risks on the way to this type of exit that can get in your way. If you get stuck with a round of Participating Preferred, it can eat up 20% of the round. Or if you bring in that professional CEO, it can cost 10% of round. Do a third round and it is all over.

Now clearly there have been some great exits that have made entrepreneurs a lot of money, but do the math. Only 20% of all companies get to an exit. Only 1% of those are over \$100M. Probably only 1/3 of those exits in favor of the founder. Those kinds of odds would make the owners of the casinos in Vegas blush. So, if you decide



to swing for the fence, make sure you understand all of the dynamics. Lay out a spreadsheet that takes into account all of the dilution of the investors and the employee options. Look for “gotchas” like participating preferred, high-end executive recruits, and your specific vesting position given a change of control. But first and foremost, make sure you are performing way above the bar. One slip and it could cost you the company and much of the return.


So why do founders take all of these risk and reach for the golden ring? Well, quite simply, a startup venture can be the ride of your life. It can be the most dangerous, most frustrating, most costly experience you could face. It could also be the most rewarding and fulfilling.

Relationships can go to a new level when a team can battle through these types of adversities and make it to the other side. Even when founders make a fortune selling one company, they often sign up for a “second tour” and start their next venture.

The rewards for winning are high. Even with a \$20M exit, founders can walk away set for life. Many then parlay their success into doing something quite significant. If they decide not to do their own startup, many become Angel investors. They bring their money and their experience to the table and turn their small fortune into a large fortune. They also have the means to invest in social causes and many focus on key issues like hunger, water, and disease. In less than 20 years, the tech entrepreneurs have gone from virtually no charitable contribution to being some of the largest contributors in the world.

*In 2011, it is one of the best times in history to start a tech company. Many of the dynamics are now in the founder's favor.*





In 2011, it is one of the best times in history to start a tech company. Many of the dynamics of the company are now in your favor. There is more Angel money available than any other time. With tools like Open Source software, the Amazon Cloud, and service APIs, it is a fraction of the cost to create a product. Distribution on the Internet makes the world your customer. With social networking, media, and blogs, marketing is nearly free and you can quickly become an industry expert within a matter of months.

Do it smart, but do it now. These trends are strong, but the tech industry follows cycles. It is a scary ride, but a ride that you will never forget. Make sure that you are prepared, make sure that you are informed, make sure you have strong mentors, but go make it happen. It will be the time of your life!