Raising Initial Funding for High Technology Companies in the San Francisco Bay Area

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Introduction

This is a brief summary of the process for raising initial funding in the Bay Area for high technology companies. We hope to help entrepreneurs seeking initial funding understand the alternatives, identify potential funding sources and, most importantly, understand the practical realities of raising initial funding in the Bay Area.

Although a number of business forms exist (*e.g.*, limited liability companies, limited partnerships, general partnerships, S-Corps), we assume that your high technology enterprise will be formed as a C-Corp. The C-Corp form is almost always selected for many good reasons. Nonetheless, under some particular circumstances, one of the other forms may be chosen. Again, the following discussion assumes that you will form a C-Corp.

Although we touch upon initial funding from the entrepreneur and "friends and family", the primary focus of the following discussion is how you can maximize your probability of obtaining initial funding from institutional angels and/or VCs. Both of these groups are sophisticated investors that insist upon thoroughly vetting your company. We want to prepare you to achieve success in this vetting process by getting the attention of institutional angels and VCs and by performing well when you are "on stage."

Seed Capital Financings

Seed capital is primarily available from the entrepreneur, "friends and family", an institutional angel investor and/or a prospective customer. Seed capital financing is needed to form the C-Corp, clear its name, create its by-laws and other corporate documents, create a stock option plan and complete other preliminary matters as well as to satisfy the validation requirements for a VC financing. "Friends and family" investors invest basically because they trust the entrepreneur, and thus the polished materials (discussed below) you will prepare to attempt to get the attention of institutional angels and VCs often are not required. Many institutional angels approach these initial financings much like a VC and want the validation required by a VC. Major Bay Area angel groups include the Angels Forum, Band of Angels, International Angels, Keiritsu Forum, Sandhill Angels and Tenex.

Seed financing usually comes in the form of the purchase of common stock, preferred stock or notes convertible into common or preferred stock. Selling common stock often is not useful for the seed financing because of the dilutive effect. Consider the number of shares at $0.01 per share needed to be sold to raise even $100. A low price of common stock, however, is useful to motivate employees and other service providers who will be granted attractively priced options or shares of common stock. Pricing of common stock must be same for all sales at or about the same time.

If preferred stock is used for the seed financing, the company must be valued. Preferred stock can be complicated and expensive to use even if raising a small amount of money. The cost of raising money should be proportionate to amount raised.

Convertible notes for "next financing" preferred stock are often used for seed capital financings. This approach defers the valuation determination and keeps the financing simple and low cost. A discount on the conversion price in the "next financing" (or warrants) is often used as a "sweetener" for taking added risk.

First VC Round

VCs generally invest via the purchase of preferred stock that is convertible into common stock. On occasion they may purchase convertible notes. VCs will thoroughly vet your company scrutinizing the materials described below if you can get their attention.

Defining the Business and Communicating its Value

Preparing and refining an elevator pitch, executive summary and power point presentation for institutional angels and/or VCs to fully understand the business, its value proposition and the execution steps is a critical part of the initial fundraising process. The following materials should be prepared for communicating with prospective investors and others. They need to be clear, concise and persuasive **because if you are unable to create high quality versions of these materials, you almost certainly will be unable to attract the attention of institutional angels and VCs:**

- 30 second elevator pitch
  This is your "attract" mode for the purpose of persuading the target person to take the next step of asking questions

- 2 page executive summary which covers the following business points:

  The Problem and Solution
  What is the pain point and how are you solving it? The product must be "need to have."

  Market Size
  How big is the market? Is it at least $1B?

  Sales Strategy and Channels
  How will you acquire customers?

  Intellectual Property Position
  Do you have protectible IP and how will you protect it? For example, have you filed provisional or full patent applications?

  Competition
  What is your "unfair" competitive advantage?

  Management Team
  Can the initial team execute at least through product development?

  Pro-Forma Financials for 3-5 years
  What initial valuation will the projected revenue numbers justify?

- 8-12 slide PowerPoint presentation
  The first bullet point of the first slide is the most important.

Be prepared to give the 30-second elevator pitch when meeting potential investors (or people who can introduce you to investors), potential customers or people who might join your team. Even your lawyer will want to hear it. Bay Area networking events provide access to potential investors, team members, customers and others who can help build a business. Make sure there is a clear "unfair" competitive advantage in the 30-second pitch — why is your company "special"? Being a cheaper alternative to a larger, better financed competitor is unlikely to be persuasive.

You will need validation of the technical feasibility of the product and its market need in order to get VC investment. This requires credible referenceable customers who will actively support the product in discussions with potential investors. You need one or more Fortune 100 type customers or a critical mass group of smaller customers. It is very difficult to raise venture capital without market validation. Validation is a "chicken and egg" problem in some spaces. In a chip business, for example, validation requires money while a software business may be able to reach validation with mostly "sweat" equity.

You will also need to demonstrate the market size is large enough (generally at least $1B) to provide investors with an acceptable ROI through an "exit event" (IPO or acquisition). Even if the product works and you have referenceable customers, most venture capitalists do not want to invest in a small business. This does not mean it isn't a good business, only that it has to be financed in another way.

Forming the Team

Your team can be assembled from friends and other business contacts and through meeting people at Bay Area networking events. In most cases, the technical founder must be from and have credibility in the business space of the company. The initial team needs to include someone who can credibly identify market requirements. Investors don't invest in technology; they invest in companies with a product that the market wants that generates scalable revenues. Defining and refining product requirements is a continuous task.

Meeting Angels and VCs

Many Bay Area marketing events provide an opportunity to meet institutional angels and venture capitalists and to learn their business segments of interest and investment criteria. There are usually a number of VCs at AAMA events and BASN, SVASE and other organizations offer small group meetings with VCs.

The best route to an institutional angel or a VC is through an introduction from someone they know such as a lawyer, accountant or another institutional angel or VC. This approach usually results in the institutional angel or VC reading at least the pain point/solution paragraph of the executive summary. The Silicon Valley Bank Venture Exchange program provides a good way to be introduced to potential investors.

In determining which institutional angels and VCs to try to meet, you should review a potential institutional angel's or VC's portfolio to make sure there is no competitive investment.

Company Presentation Events

There are several organizations in the Bay Area, which provide regularly scheduled (usually monthly) opportunities for entrepreneurs to present their companies to potential investors. These are so-called "amplification" events because an entrepreneur can reach more prospective investors with a single presentation. Each organization has a screening process and some charge entrepreneurs to present. Several of the organizations focus on a single business segment in each meeting since investors interested in the space will be more likely to attend if there will be a number of companies of interest presenting.

Two places you can meet institutional angels are:

- International Angels (angelinvestors.org) — This is an angel group primarily in seed capital investment. Investors are spread over a variety of business segments including some non-traditional technology businesses.
- Bay Area Startup Network (basn.org) — These events have both angels and VCs in attendance. Investors attend for both seed capital and initial VC fundings.

The following organizations have only VCs in attendance and pre-qualification of companies is rigorous. Companies presenting need to have the product and customer validations necessary for first round VC financing:

- IDB Network (idbnetwork.com)
- Right Hand Partners (rhpartners.com)
- Deloitte & Touche Accelerator Sessions

Use of Finders

You may be approached by a "finder" who offers to help you raise money through introductions to prospective investors. Do a reference check on the finder's track record. If the finder is asking for a "success fee" then the finder needs to be a registered broker dealer under federal and state securities laws. Institutional angels and VCs will not look kindly upon the use of a finder who has a claim to cash from the proceeds of the investment. Introductions to institutional angels and VCs can usually be arranged without the use of a finder.

Venture Lending

Once a first VC round has closed that includes material VC participation, it may be possible to obtain additional financing from institutions that specialize in venture lending to early stage companies, which may be pre-revenue. These financings help extend the companies cash. A critical factor in the decision of these lenders to enter into a financial arrangement is the quality of the VCs in the first VC round. Inevitably these lenders will receive an equity "kicker" usually in the form of company warrants. The lenders are banks (*e.g.*, Comerica Bank, Silicon Valley Bank, Bridge Bank) or funds (Western Technology, Lighthouse Capital, Gold Hill Capital, Pinnacle). The banks and funds tend to have somewhat different deal terms and deal size limitations.

Basic Legal Issues

Federal and state securities laws need to be complied with in selling securities to investors. Investors have, in effect, a money-back guarantee from the company and possibly its officers if you do not comply. Borrowing money from persons not in the business of making loans is a security under these laws. You should seek investment only from accredited investors or a tight circle of friends and family.

Due diligence by both professional angels and VCs includes a hard look at intellectual property ownership. An initial focus will be the relationship of the technical founders to their prior employers' technology. In California, even if the technical founder has not used any of his prior employer's resources, trade secrets or other property, the prior employer may have a claim to any inventions that relate to the prior employer's business or actual or demonstrably anticipated research or development. In today's difficult financing environment, there is much tension on this issue because entrepreneurs are reluctant to give up their jobs without funding. This means there may be a “hot” departure of the technical founder from the old employer and a “hot” start at the new company without any cooling off period or, even worse, an overlap of the technical founder working for both companies at the same time. Some entrepreneurs underestimate this risk since their perception is that many Bay Area companies have been started in the past by entrepreneurs who leave a company and start a company in the same space. Trying to delay a departure until funding is imminent is very risky and may in fact materially reduce the probability of funding. Investors will not want to buy into a lawsuit.

Another key due diligence item is rights to stock and other equity. The entrepreneur needs to have discipline in promising stock both to reduce claims to stock and to comply with securities laws. Adopting a proper stock option plan at the time of incorporation provides a securities law exemption for providing equity incentives to team members and others.

We hope this summary will help you understand the realities of raising initial financing in the Bay Area. Now go get your money!

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