Transcript - 2022-01-11
"TENFL Preparing Fundraise Content"

0:00:40 Section 1 -- How to prepare for a fundraise.

Hall Martin: Today, we want to talk about how to prepare for your fundraise. We get a lot of people coming in with a great idea, they want to go to the next level with it, but they don't quite know what they need to be doing to take their idea and go out to the marketplace to raise funding. And so, I wanted to walk through those steps here. Like I say, if you have any questions, go ahead and post your questions in the chat box over here, so we'll be able to answer when we get finished with the slides or just take a few minutes to go through the slides, and then, we'll kick into it. So with that, let's go ahead and kick off and look at _________ about starting to raise funding. And one of the first things investors are going to be looking for after they figure out what your product is, and the problem you're solving, that's what you always start with, because they need the context, is how big is that market. And you need to go and research the market that you're in, and you want to look at the market in three ways, the total available market, that's the big, big number, that's multibillion dollars that investors want to see, because they want to know it's just going to be a very large market. Then there's a serviceable market, which is the market you're really trying to go after. And then there's the beachhead market, which is the first 20 customers you're going to go after. And the beachhead market is important because it shows you know how are you going to get into the market, and it's great to say, here's the top 20 contacts you are going to go after in this first niche, and, oh, by the way, we've talked to everybody and they like what we're doing, and that shows people you have an entry in the market already. The thing you want to avoid saying is here's a multibillion dollar market, and if we only get 1%, we'll have a $100 million company, because the problem with that is it doesn't tell the investor, you know where or how you're going to start, you already have to have figured that out, and you want to communicate that on the market slide. And the way you figure out these markets is you go on the web and you start to do some research, you don't buy research reports, they'll sell you those for $5, $15, $20,000, but what those are basically a compilation of some direct mails that people responded to. And if you go on the web and just put in there things like what is the size of the ecommerce market, you'll start to get the numbers through Google pretty easily.

The other thing you look at is trade associations and conferences, these groups are usually based out of Washington, DC, because they do political activities as well as market sponsorships and so forth; and there's often some really good research guides out there that you can use to figure out what the size of the market is as well. And if you ever get a chance to go to a conference around it, you'll find that's a great way to find more information, just talking to people, they know the numbers, they'll tell you those as well. Here in the COVID times, you don't get to do that as much as we used to, but certainly, that's one way to learn about your marketplace. So know what your market is, and be in a place where you can actually go out and talk about it intelligently with numbers. You always need to put numbers in these things because it makes it more specific, and it also makes it, it shows that you're an expert, you know your business very well. The second thing the investor is going to be looking for after they figure out what your product is, and what your market is, is what's your business model, how are we going to make money in this place with the product itself. And here's an example set, we won't go through all of them. But you can think of it as there's a brokerage model, more like bringing buyers and sellers together, there's an advertising model where we're going to promote services on top of our – to our audience that is looking at it. There's a merchant model where we're going to sell goods either wholesale or retail. So there's different ways of monetizing, and when you go to look at the market, don't set your heart on one business model up front, be open to three or four different types of business models and test it out. It's so often the case, you get in there and find the market that you want to go after is crowded with competition or is not making enough money to make it worthwhile, and so, you have to switch to another model. So come up with two or three approaches to your business and just brainstorm to see how can we do this differently than others that are out there as well.

The next thing is, and I get this a lot, people used to bring me 50-page business plan books, and they were struggling because they're trying to figure out all the details of the business, all the operational details they wanted, they're supposed to write down. We've gotten away from the 50-page business plan books, people don't do that anymore, thank goodness, because in the very early stage for a startup, you're constantly iterating and changing plans. And so, instead of looking for the business plan, look for the business model and hone the business model, don't worry about all the operational details just yet. Show how are you going to generate revenue, and then show what costs you have to put into place to do it. I have to do these things to make the customer happy, and here's how much they pay us for it. And oh, by the way, that's a profitable business model – I make more than I have to spend to make it work. And so, this is the thing you want to do is really focus on how the business model works, and really understand it very, very well. Later, you can fill in the details of the operational side of the business plan that you go with it. Here's the other one that I find people struggle with a lot is they come to me with a vision, and they have in their mind what this product is or will do, and they – but the challenge is it's a very complicated product, it's a very complex one, so often a platform-based business or what have you, and they want it, they're ready on day one. And that's a challenge because platforms take years to develop and takes millions, in some cases, millions of dollars to develop. And so, you're not going to have that on day one, and the successful companies I've worked with, they typically came to the market with a simpler version of the product. That's what you see there. The product that you market to the customer – customer wants X, I made X for them; and then what we found is that you really need more than just one product, you need three products. The first product is the product that you want to make and market out there. The second one is the product that generates cash, and this is often ancillary services that go around that product. Once they buy that product, they need additional support or they need additional maintenance or they need additional whatever, and they're paying money for that in an ongoing fashion. They typically, when they buy your product, they bought it once, but with the services, they continue to pay for it over a period of time. And finally, there's the product you want to build and this is typically the platform-based business. And if you set it up this way, well, then you have a steady flow of customers, and you have revenue from those customers to help you fund that SaaS-based businesses. Again, if you come in and you want VCs or angels to pay for or fund a very large platform-based business, you'll find that to be very hard and very expensive. Start with something small and simple, because it'll teach you about the market, it'll build your brand name, you'll learn about the competition, you'll figure out where the customers want you to be, and where they don't want you to be, and use that upfront for the first year or two, and then start adding services on to it and then work to build a platform-based business that comes out of it.

So the next one is instead of building a business plan, book or whatever, come up with an executive summary, a one-pager, and describe these elements, what is the problem you're solving, and what is the solution you offer, and then what is the product that you're actually bringing to the market as part of that solution. Talk about your competitive advantage, don't say you don't have any competition, because many investors look at that in saying you have no market. If it's a good market, there will be competitors. It's, in fact, competitors validate the market. If other people are doing it, then you can too. That gives investors confidence that you're in a place where people are making money. And then, next is your target market, and we talked about that before, your total available market, your serviceable market, and your beachhead market to show how big this is, and what section you're going after. Then talk about your business model, how are we going to make money, is it recurring revenue, is it transaction fees, is it brokerage fees, what exactly is it that you're doing there. And then the sales model talks about how we're going to sell the product, and this is primarily the channel, are we hiring direct salespeople, are we using affiliate marketers, are we working with referral partners, how are we going to actually get the customers in the door and close them. Next is intellectual property, trade secrets, patents and copyright. You want to put that in there as well.

For the team, you want to show that everybody is competent and has experience. Then you want to put a thumbnail of financial projections, not to say that you can predict the future, but it demonstrates this is what your expectation is – if I raise this money, I expect this to happen. And it just communicates your vision to the investors in a better way. Then you want to show how you're using the funds and how much you're raising, and then you finish with the exit, who will buy you and why. So this is a thumbnail for what you want to put together at a high level, and then you can also put this into a slide format where there's one slide for each of these is a good way to start your presentation. Another thing you want to do is create some content around your industry and your product and have a good messaging that tells your story. Whenever you promote your startup, there's two things you need, you need a story, why will this be successful, how will it work, how did I get into it. Those are all great elements that engage the investor and educates them. And two, you have numbers that validate it – we sold this many people, we have this growth rate, we have this CAC/LTV ratio. Numbers back it up and make it real. So you need a story, and you need to back it up with numbers. And so, in your marketing, you want to make sure that you have meaty content here. And so, you know the audience, you know clearly what they're interested, how they work, what they pay, and so forth. Two, and this is very important, I always tell people, when you start your presentation, in five words or less, tell us what the product does – we make radiation-hardened memories, whatever that is, tell it in five words or less, so they get that firm positioning in their mind, this is what you do. I find many, many deals and presentations skip this part because they assume others know it. We call it the "curse of knowledge", because you know it so well, you think everybody knows it. I used to watch presentations, and I would time it to see how far into the presentation before I could actually figure out what they did. And you shouldn't be letting that go on, you should tell the people that right upfront. Create a list of topics that are interesting for this, and use this to write articles and blog posts to help do marketing. It takes a little bit of time, but it demonstrates your expertise, and it's a great way to reduce your marketing cost that goes out there, because you can use these in blogs and on social media, and you can actually reformat and repurpose content from many different platforms that are out there. So consider doing a little bit of content work on it.

In intellectual property, you need to think through your strategy there. Typically, the first thing you want to do is as many things as you can put in trade secrets you do, just put that aside and keep that in a way that other people don't know how you do something, protect that, don't make that public, and you'll find that that's one of the best ways to keep your intellectual property secret. For things that you need to actually patent, what you want to do is follow a number of provisional patents. Right up front, most people have filed two, three, four provisional patents, they're not very expensive, they're things you think will go protect you, and they give you one year in which you need to figure out which of those patents are going to really give you protection and which are not. For those that are going to give you protection, well then, at the end of the year, you turn it into a full design or utility patent itself. Then there's copyrights and there's trademarks, you want to think through how you might want to copyright what you're doing, and how you might want to trademark your different technology. My rule with products and with startups is that for every platform, every product, every dataset and every technology you have, you have put a name on it. I am amazed at how many people bring me a startup, and they have all this revenue going on, but I can't quite figure out where it's coming from; and it turns out, they've actually not given their product or platform any names, they're just referring to it as revenue. You want to actually to make yourself look like a bigger company, put a name to it, a meaningful name that says something that fits the industry and tells the user a little bit about what it is, because now it gives them a sense that that's what we want to get out of as well. So let's talk about those as we go forward.

You'll need to have a term sheet. My recommendation is you're always in a place to take money. If in the early stages, you want to raise funding, start with a convertible note, have the convertible note ready, you know, standard valuation cap interest rate discount, it's really not hard to come up with those for the early stage. But you're always at the ready, so if somebody says hey, I want to be in, boom, they sign the convertible note, they sign the check, they're in the deal, the money goes into the business the next day. So never say I'll come back to you when I have a lead investor. The convertible note doesn't require a lead investor. And for people that just want to be in the deal, this is a great way to capture them. So always have that note ready when you go through the process. And then, like I said before, let's make sure that we have our patents put together. The reason I say this important to do before the fundraise is that I'll _________ half the value of a patent is with raising money from investors. The other half is protecting the business later. So it counts for a lot with the investor. So file those before you go out, because what the investor is going to want to know is what was filed, when was it filed, and have there been any office actions on it, any approvals or any questions or whatever. So make sure we have those done. If you have anything that's confidential, the first conversation should not require an NDA or what's called a non-disclosure agreement. I used to get this a lot – people will say I've got this great deal, but I can't tell you anything about it until you sign my NDA. Well, investors don't want to sign non-disclosure agreements, unless they know what they're signing it about. And so, you have to have some level of information that says, here's what we do, and the secret to this is, you don't have to tell them how you do it, all you really need to do is tell them what the benefits of your product, what the product can do, but not get into the how we do it part. And you'll find that you can have a lot more open dialogue with them. And then when the investor gets into the diligence process, well, then it's fair game for them to sign NDAs at that point.

And then, the first – always tell people, it's great to raise money from your family and friends and from yourself and from your local area, angel group, or your network, always make sure you cover that. But from day one, consider a national perspective on your fundraiser. Don't just stop at the edge of your city or the edge of your state. Think how am I going to raise money outside from across the country when we go forward. And it's great to go to people in other states and say, hey, I put money in, my family put money in, and my local angel group put some money in, and we just need more. That's really great validation. What you don't want to do is skip those steps, go out and then say, well, nobody back home giving money, how about you, because that's not very good validation, and it's going to be hard to raise money. And start looking hard at networks of angel groups across the country and crowdfunding – crowdfunding is coming up, it's doubling year over year, billion dollars invested last year, so it is a great way to look beyond your borders once you have that initial investment.

So let's go over here, we had a question so far. If anybody else has a question, go ahead and pop it in there. So, are some business models preferred by investors more than others, subscription versus service, and does this make a big difference? And thank you William for the question. I think that's a huge differentiator. If I go to sell my business, and I have recurring revenue, I get a 10 to 20x valuation on the revenue. So if there's a million dollars, I can sell it for $10 to $20 million, because that's what subscription services bring out there. If I build a custom service business where there is no recurring revenue, it goes for 1x to 1.5x times revenues, so that million dollar business, if it service, it's going to be worth $1 to $1.5 million and no more. And I have many companies coming to me where they are later stage, $10-$20 million of revenue, they're thinking about selling the business, but it's a service business, not a subscription business, and now they're going back raising money to convert the business over to be subscription. So in the very early days, you may want to use some service work to learn the market and get into it, but as soon as you can switch to subscription, you do so because the valuation's there, and the scalability is there as well – much, much easier to scale a subscription business than it is to scale a service business, because of the way it's structured, so by all means it's very much preferred by the investors that are out there in the marketplace.

Anybody else have any questions here about your business and what you're doing? So the next one is, any thoughts about funding for a hardware SaaS model, IoT hardware with recurring revenue. This is very much the same thing, you'll hear now the phrase hardware as a service. So even though it's hardware, you can actually slice and dice the cost of it, so that you're actually charging for the use of that hardware on a monthly or quarterly or annual basis. So don't let the hardware throw you off. You don't have to just pay for the hardware once you can set up the business model, so that it is recurring as well. And hardware as a service is coming in a bigger way. It helps to bundle software and maintenance and other elements into it, so that there's more sources of value add. If it's just a piece of hardware, some people will push back. But when you're upgrading it with new firmware, and you're replacing it, if it breaks, and if you're maintaining it once a year through whatever, then you'll find it's not hard to sell that package as a recurring revenue bundle itself, especially when that goes. And then that's the other side of it is the analytics that come out of it, it can also be monetized. So what I often see is a business where they come in and they're selling a product, I've got this device that checks the condition of your ear, for example. We saw one the other day that did that. And the vision was to sell that product to somebody, and then they would collect the data, and they were able to sell the data to medical device manufacturers. And so, step one is they were selling the product. But step two is they were positioning themselves as a data analytics provider. And then, step three, when they had enough data, and they can actually do meaningful analysis, they were going to be an AI, you know, an artificial intelligence machine learning company, where they could actually provide diagnostics and other treatment tools based on the data that they did. If you try to do all three in one go, you'll find that very hard. So in many cases, you're doing in year one, the hardware, getting it out the door; years two and a half to three, you're starting to build datasets and sell those datasets; and then year four, you're moving into the AI space. The way you want to handle that is you want to put a roadmap slide in your presentation deck that says we are a data analytics AI company, but we are in year one of a five-year plan, here's where we are on the roadmap. And people will appreciate the fact that you're getting out there, building a base, you're earning revenue upfront, but you have the vision of designing this in a way that it will be a data solution and an AI solution. So make sure you put that slide in there because they may not get that vision from just the picture of your product as well. So that's a good question there, thanks, about the analytics as the service because that's a continual recurring revenue stream in most cases.

And then the next question from Zeev is: are multiyear model service contracts two, three or four years considered subscription services? Well, if you're selling the contract and it's month to month, well, then that's a monthly contract. If it's sold on an annual basis, that's an annual contract. And some businesses are just unsure of their future, so they will only sign monthly contracts. Some want the actual price discount you may be offering, so they'll sign the annual contract as well. So recurring revenue is great, but they just call it one or the other MRR or ARR based on what the frequency of the contracts or the length of the contracts that people are signing. And if you have a multiyear contract, well, then that's even better. So now you have something that people will sign up for three or four years, and typically, they're getting pretty good price discounts, because they've signed up for such a long period of time. The drawback to that is if you plan to raise your price, you cannot raise it in most cases, until the contract is up. So you have to model it so that you don't leave money on the table there as well.

So any other questions there, guys? These are great questions as well. Looks like people are really doing some cool things out there, and love to hear about your business. If you have a specific question about your business, you can also unmute and come on the video and ask us your question about your specific things. We get a lot of questions about how much to raise, how to structure the raise, what term sheet to use for the raise. We can help you with those questions as well.

00:24:31 Section 2 -- What are commonly used term sheets for startups?

Hall Martin: So the two most often tools we see is the convertible note and the safe note. While they're fundamentally structured differently, they really act the same, and they're pretty much interchangeable. The safe note is actually a warrant that gives people a right to buy the stock later, and you're on the cap table. The convertible note is a debt instrument that converts to equity later. And they all – both of them have, can have an interest rate and a valuation cap component, and a discount rate. And the interest rate is how much you earn while you're holding it. The discount rate is how much more shares you get when it converts, because you came in early. And the valuation cap just says the valuation won't go above this rate ever, when we go forward. And so, the reason you want to use those is that you're really not setting valuation, you're setting a limit on the valuation, but we're not getting into the valuation, and that's a great place to start. You don't want to make investors at the very, very early stage, climb the valuation while I say it, because it can be very hard to figure out what the business is worth, when there's not much there. And so, let's just delay that till later when we can have more there, and we can all agree upon what the valuation is. I often bring people in saying, nobody wants to lead the deal, which means to set the valuation, well, let's not have anybody lead the deal, just use a convertible note, and then you're just in the deal. And later, we'll figure out what the valuation is. But there's some safeguards on it. So if you go to the National Venture Capital Association website, nvca.org, you'll find some really good examples of convertible notes up there. They have what are called model legal documents, and that's a great place to go pick up a convertible note. If you want to look at the good safe note models, you go to the Y Combinator website, the letter ycombinator.com is a great place where they have a really good rich list of safe notes because they have different variations. Some have interest rates, some don't, some have valuation caps, some don't, some have discount rates and some don't. And so, there's a variety there to pick from. FYI, you will find it very hard, you'll find it challenging with some investors if there's no valuation cap on there, because you could just put any valuation on there next round, and many investors are not up for that. And so, those are the two places I go look for model legal documents.

Speaker: So the valuation cap itself, does that require an estimate of the value of the company to start with, or you just throw out a number or?

Hall Martin: So what you're doing is you're saying that in this valuation it will never go above that for the investors that came in early. When you come in and you're setting the valuation, you're looking at what are other companies going for that are like my companies. As we discussed earlier, SaaS companies, for example, have a 10x valuation lift, in most cases. A million dollar company is worth $10 million on the valuation. If you're a service company, it's more like 1.5. And so, you're setting the valuation, which is usually what we call – we use the term comps for comparables – you're looking at similar companies and what they're going for. Valuations go up and down with two things, number one, what is in the business today, how many sales do we have, what quality is the team, what the state of the product is, is it shipping, is it alpha, beta, final, and intellectual property – those are elements that people look at to say, what's really in this business. And the other factor is the stock market. When the stock market is high, like it is today or at this timeframe, you'll find the valuations go up; when the stock market goes down, valuations go down, because fundamentally, they're keying off of exits. When that SaaS business gets to a later stage, a $100 million, and they sell the business, those who buy them are establishing that M&A valuation, and you're looking at that, what's called a multiple, it's either a multiple of revenue or multiple of earnings that says this is what will pay for these businesses at the exit level, and that kind of flows back through the system to the early stage. And like I say, the market is very high right now, so you'll see valuations are very high also.