equaliFi ACADEMY

AIM

CERTIFIED ALTERNATIVE INVESTMENT MANAGER®

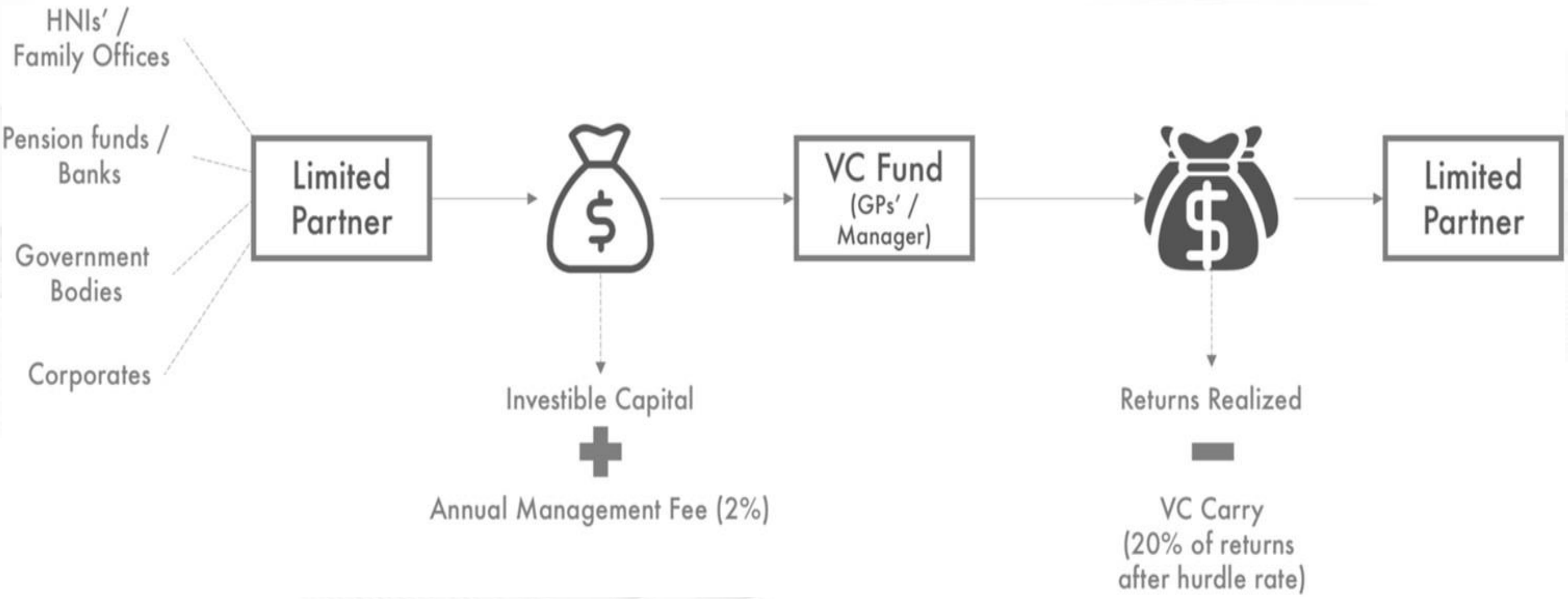
Introduction to Venture Capital and Life of VC funded entrepreneurs

Agenda

- **Part 1: How VC funds work | History of VC**
  - 2/20 rule, GP contribution, example of a new VC fund cashflows, Indian tax laws applicable to LP money and carry, careers in VC industry
- **Part 2: Funding and Stages of Evolution**
  - Constraints in VC business, strategy and stages of funding, startup valuation, up rounds and exit modeling with an example, basics of a termsheet
- **Part 3: Life of a founder**
  - Motivations, challenges and opportunities of being an early stage founder, start-up as a way of life / career, life after exit, IPOs, the high-performance entrepreneur

Part 1: How VC works

How VCs work - incentives & economics



Fund Example

- $100m fund, 2-20 structure, 10 year horizon
  - Investible corpus = $80m

- If Reserve Ratio is 1:3 and first cheque size = $1m
  - Number of cheques = 20

- If GP Contribution is 5% and if exit is 3x on fund size, cashflow looks like this:

	Assumption	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13	Year 14	Year 15
Funds Raised	100	0	100	0	0	100	0	0	100	0	0	100	0	0	100	0
Exit	3	0	0	0	0	0	0	0	0	0	300	0	0	300	0	0
Carry	20%	0	0	0	0	0	0	0	0	0	60	0	0	60	0	0
Fees	2%	0	2	2	2	4	4	4	4	4	4	4	4	4	4	4
GP Contribution	5%	5	0	0	5	0	0	5	0	0	5	0	0	5	0	0
Total Cashflow		**-5**	**2**	**2**	**-3**	**4**	**4**	**-1**	**4**	**4**	**59**	**4**	**4**	**59**	**4**	**4**

What VCs Do

Venture Capital Value Chain

Fundraise

General Partners at VC firms raise capital from Limited Partners (larger institutional investors & HNIs)

Source

Discover interesting startups to invest in

Invest

Do due diligence in the sourced startups,and then invest in the startups in exchange for equity stakes and board seats

Add Value (portfolio mgmt.)

Add value to the invested startups (portfolio) by active participation (strategy, talent search etc)

Make Money (hopefully)

Make money when the startups go public (IPO) or are acquired (M&A)

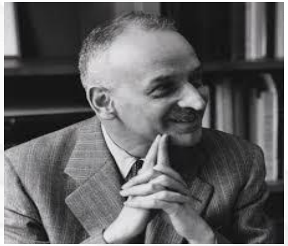
History of Venture Capital

Roots of venture styled investments can be traced back to Whaling in the 19th Century - you bet on a ship, its captain & his crew to hunt whales

Investments in whaling were **very risky, but rates of return on capital were very high** compared to benchmark investments

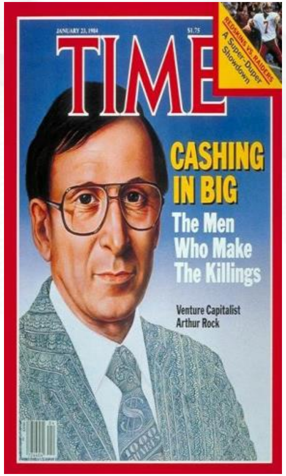
The whaling industry was one of the earliest to grapple with complex issues in relation to the provision of **high-risk investment capital, syndication, organizational form, ownership structure, incentives, team building and principal- agent tradeoffs**.

Venture capital with institutional investors, as you know it today, starting taking shape in the mid 20th century in the US



Georges Doriot - French born American Founded American Research and Development Corporation in 1958.

Father of VC. Also founded Insead.



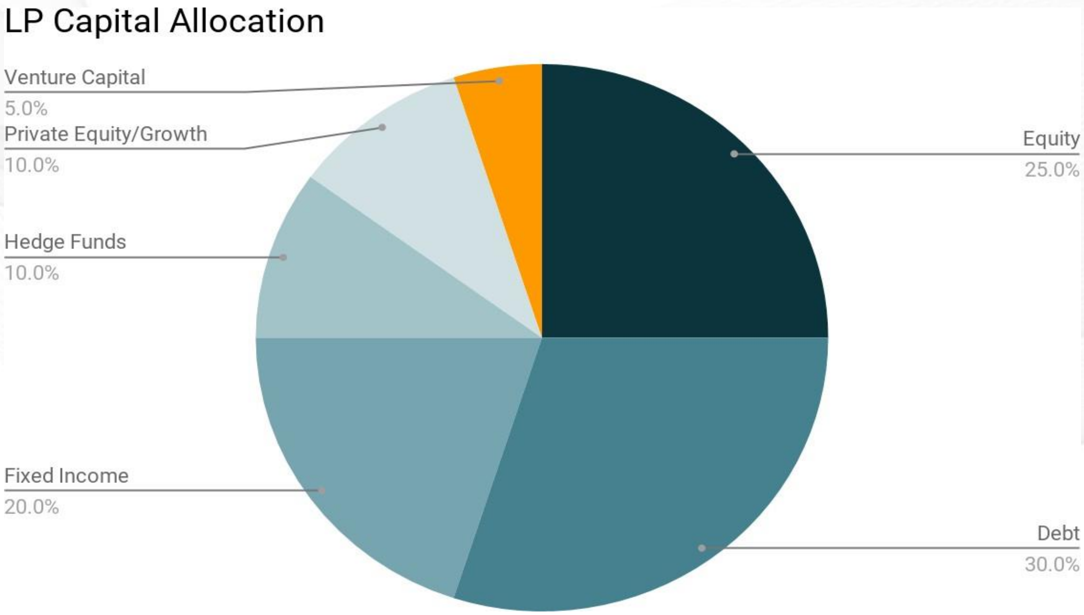
Arthur Rock.
Early investor in major firms including Intel, Apple Computer, Scientific Data Systems and Teledyne.

Traitorous Eight & Fairchild Semiconductor
William Shockley Transistor backstory

The Top 5 companies by MCap today were all venture funded

The Big 5 are collectively worth around $4 Trillion. That's 1.5X the GDP of India!

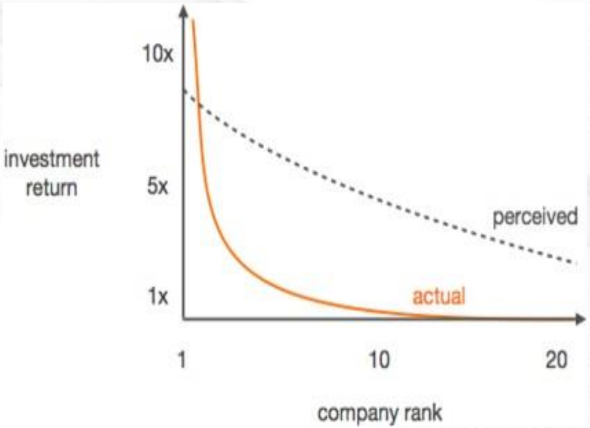
Venture Capital is the riskiest asset class in the LP's portfolio - therefore, by nature, demands the highest expected returns

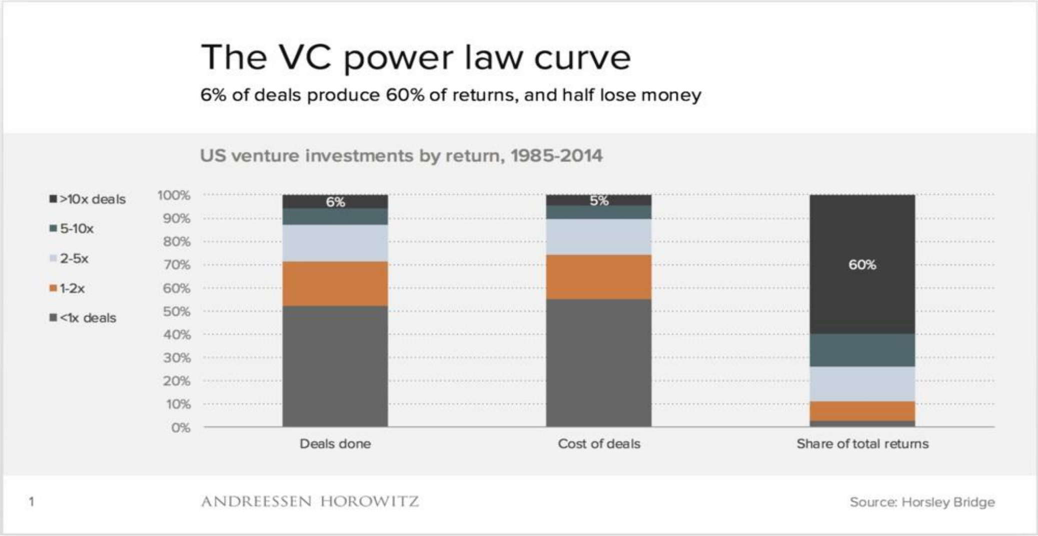


Each asset class has a different risk-reward profile. Higher the risk, higher the expected returns from that asset class.

Venture Capital is the riskiest asset class. Therefore, VC also demands the highest returns.

While VC demands the highest returns, it is also governed by the Power Law - 6% of the deals produce 60% of the returns, and half lose money.





Therefore, **VC money primarily goes to rocketships** - startups that have the „**potential**" of achieving „escape velocity" to „reach the space" and **generate outsized returns**.

Legal Structure and Definitions in India

- SEBI regulates VC funds in India under the AIF rules. Category 1/2/3 are used for separate purposes. LPs are expected to disclose their identity to the regulator.

- Each fund has multiple LPs and one administrator. SEBI delegates the responsibility of ensuring proper functioning of the fund to the administrator. The administrator ensures the fund mandates are fully followed – documentation, auditing, conflicts of interest etc.

- The administrator then reports to the regulator about the way fund has conducted itself. This also build future reputation of the manager.

- In India, AIFs are considered to be „pooled vehicles‟. This means the contributors get direct benefit of both profit or loss from taxation perspective.

- Fund income, both fee and carry attracts income tax. Fees also attract GST.

Career in VC industry in India – Part 1

- Private Equity in India has had a much longer history than VC. VC as a phenomenon only about 15 years old and many funds have only just begun.

- PE in India has raised and returned a lot more capital largely through IPOs. For example, ChrysCapital has just raised their 8th fund. Since their deal sizes are large (think, 50m+) they don't need a large team. Their business doesn't require them to be very visible. Hence, they are relatively low-profile though require astute understanding of structuring and number crunching.

- VCs in India are of two flavors – those who are offshoots of foreign firms like US or China. Sequoia is the largest of these and employs about 50 people, 25 in the investment team.

- India-based fund managers began their journey along with Blume. Given lack of risk appetite and the track record of asset class, fund managers raised first funds most from HNIs and FOs.

- All put together, VCs in India employ only about 400-500 people, including entry level folks.

Part 2: Funding and Stages of evolution

Funding options for startups: Please be driven by the business you are building not the fund raise you are achieving!

- Personal investment
- Friends and Family
- Crowdfunding
- Incubators & Accelerators
- Trade equity or services for support
- Bank loan or credit card line of credit
- Advances from strategic partners/potential customers
- Small business grants from the government
- Angels
- Venture Capital investors

Funding options for startups: Equity based funding options for startups

- **Self / Spouse**
  - Easiest, high hope of return, high involvement
  - Financial security at stake

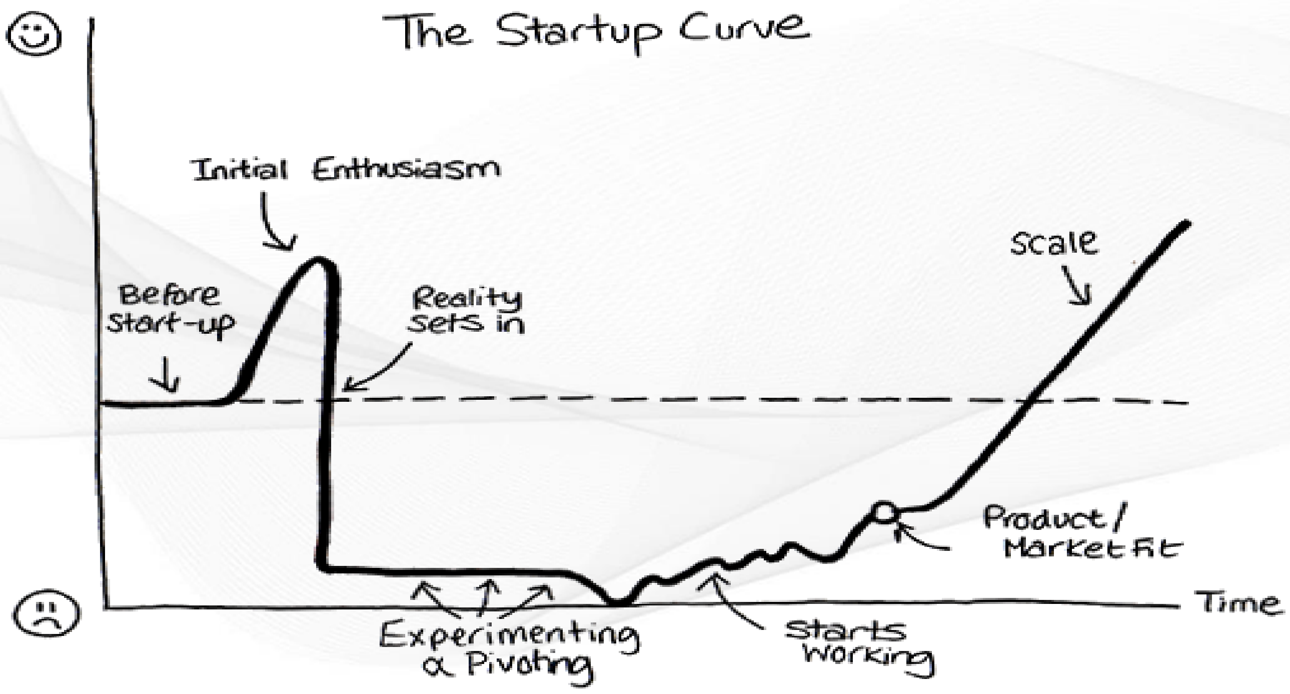
- **Friends + Family**
  - Quite easy, far more forgiving on expectation of return, low involvement
  - Relationships at stake

- **Professional Angels**
  - Reasonably difficult, takes quite some time in closing, high expectations on returns, mostly hands-off
  - Frequent „hawkish“ attitude, organizes in bigger networks

- **Venture Capitalists**
  - Most difficult, highest time to closure, longest-term relationship
  - Professional management, well-connected people, pressure to grow fast

Stages of a Startup and Valuation

Stages of Evolution of a Startup

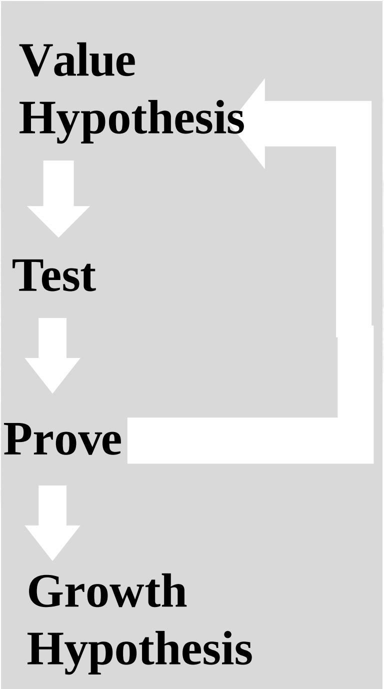


Product-Market Fit (PMF)

- Before you begin, everything is ZERO. Ideas, are dime a dozen. Unless an IP is involved.
- Only when someone arrives at first paying customer, it can be worth something.
- Hence, at the beginning, raising money from people who didn‟t know you is so hard.
- Step 1 is to build a Minimum Viable Product (MVP).
  - Product without many frills, establishes a concept how the product might work.
- Step 2 is to hit the market, seek customer feedback and figure how to sell better.
  - If this MVP is not working, get back to Step 1. If working, move to Step 3.

Step 3 requires you to find a predictable sales mode.
  - You know how to find these customers, build the product and sell it to them profitably.
  - This is called achieving *Product Market Fit*.

- Value of the business increases as the risk is coming down.



—If you address a market that really wants your product — if the dogs are eating the dog food — then you can screw up almost everything in the company and you will succeed. Conversely, if you're really good at execution but the dogs don't want to eat the dog food, you have no chance of winning.‖ Andy Rachleff

Risk-vs-Reward in a high mortality scenario

- At early stage, particularly pre-PMF, startups have a high death rate.
  - Even funded companies have death rate of about 30-40%.

- Riskiest asset class, only next to gambling. No return is a reasonable scenario.
  - 75% of VC funds may not return principal.

- Entrepreneurs have to tread carefully between high growth (high burn) and death.
  - Sometimes the difference is just 1-2 months of cash.

- An important aspect of startup funding is „size of round" and „stage of funding".
  - Each round has to comfortably take it over the next logical milestone to raise next round.

- In worst case, a bridge round has to be given to pursue a path to survival or exit.
  - Things may still not work out.

Startup Valuation

- Concept of valuation remains the same – sum-total of future positive cashflows.
  - Still, DCF method is not useful since most startups don‟t have predictable cashflow
  - How do you value an app-based taxi service when 100% of taxis in past were hailed?

- At early stage particularly, valuation is more an outcome of demand-supply than otherwise.

- Still market evolves to rough thumb-rules widely accepted:
  - Typical valuation post-PMF is $10-15m. Round size at „Series A‟ is $3-5m
  - Round dilutions are rarely below 10% or more than 35% at early stages.

- But before pricing, comes the decision – whether you want to buy or not.

Pre-Money and Post-Money valuation

- **"Pre-Money Valuation"** = Valuation given to the company before the new money is invested
  - Allows us to calculate the share price and the % of the company being sold

Price = Pre-Money Valuation/Pre-Money shares outstanding

% Sold=Shares Issued/Post Money Shares outstanding = Funding/ (Pre-Money+Funding)

- **"Post-Money Valuation"** = pre-money valuation + the amount invested.

Pop Quiz

Prof. Arya Kumar invests $2 Mn at a $10 Mn Pre-money in a Pilani startup. What %age ofthe company does he own?

A) 20% , B) 16.67% , C) Too late in the afternoon for Pop quizzes!

Stages of Startup Journey

Stage	Benchmark metrics	Typical Investors	Round Size	Dilution
Seed Stage	E-Commerce GMV: ₹0-1L / month B2C App MAU: 0-50k B2B SaaS ARR: $0-50k	Friends, Family, Angels	₹50L-1Cr $100-200k	10-20%
Early PMF Stage (Angel Round)	E-Commerce GMV: 5L / month B2C App MAU: 150k B2B SaaS ARR: $50k	Angels, Seed Funds	₹1-3Cr $200-500k	10-15%
Late PMF Stage (Pre-Series A)	E-Commerce GMV: ₹20L / month B2C App MAU: 500k B2B SaaS ARR: $250k	Seed Funds, VCs	₹3-6Cr $500k-1M	15-20%
Series A	E-Commerce GMV: ₹1Cr / month B2C App MAU: 2M B2B SaaS ARR: $1-2M	VCs	₹20-33Cr $3-5M	25-35%
Series B	E-Commerce GMV: ₹3Cr / month B2C App Revenue: ₹1Cr / month B2B SaaS ARR: $3-5M	VCs	₹44-65Cr $7-10M	20-30%

Typical round sizes, funding stages, and major players in India + Where do we fit in?

Friends and Family	Angel	Seed/Pre A	Series A	Series B & C	Series D & Beyond	IPO
$5 - 100k	$100-300k	$300-2m	$2-10m	$10-50m	$50m >	

Indian Angel Network

BLUME

ACCEL PARTNERS

Fundamentum

TIGERGLOBAL

STEADVIEW CAPITAL MANAGEMENT

Lightspeed

matrix PARTNERS

SAIFPartners

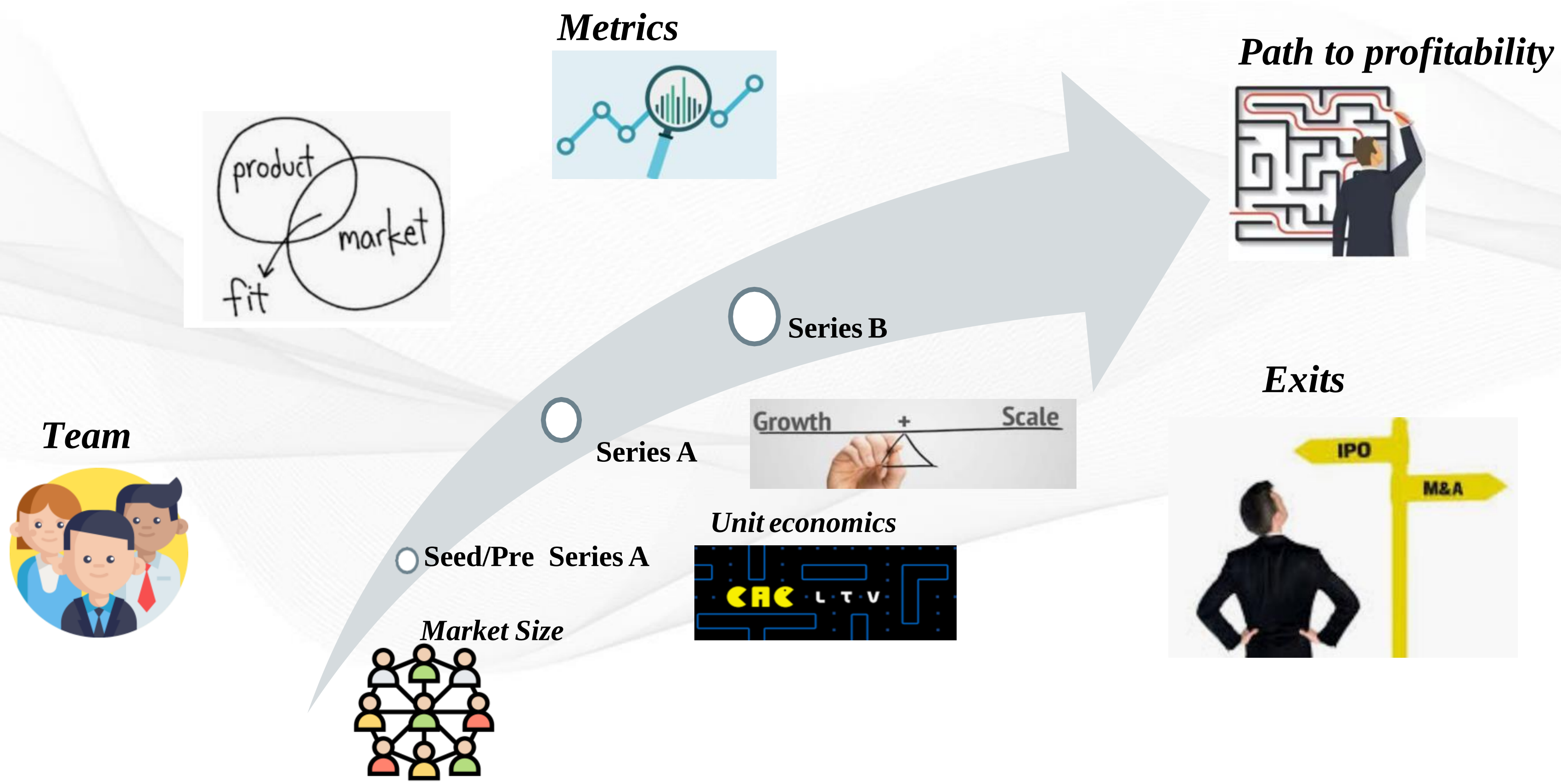
SEQUOIA

NORWEST VENTURE PARTNERS

SoftBank

How do VCs evaluate an investment?

Imperatives for investors at each stage of funding



Constraints in our business

- You are not much of an investor if you are not intent on making money. Hence:
  - You will stay away from things you don‟t reasonably understand
  - You won‟t invest as a „social service‟, that something *needs* to be funded.

- Good to have constraints:
  - Some VCs want to avoid investing into a competitor of an existing portco.
  - Most VCs won‟t invest into things that are not in their target segment
  - If a startup is looking like it will have a longer gestation than 5-7 years, VCs won‟t play
  - It is rare for VCs to invest into un-differentiated plays
  - Also, it is rare for VCs to invest into companies that *won't scale*

- Constraints observed by the market, applicable to India:
  - Follow-on funding is generally hard. Series B is harder than Series A, and so on
  - Exits are simply not happening in enough volume. Part of the reason is deluge of money.
  - Deeper tech investments find it generally harder to raise money

Founders who scale – Best of the lot

- Not motivated primarily by money
  - Nuance: you only make money with people who want to make money
  - Relatively low needs – EMIs, kids, spouse not working

- Strong inter-founder chemistry and trust
  - People who have known each other for a long period of time
  - Couples in India may be okay as long as both bring a key skill to table

- Sense of purpose and a goal bigger – missionary zeal

- "*Stay Hungry, Stay Foolish*"

Other considerations – Founding Team heuristics

- The founding team needs to have the hunger and capability to deliver the exit.
  - Team not growing fast enough over last 1-3 years – not hungry enough
  - 45+ years old founders – not foolish enough, lifestyle tendencies
  - Ivy League founder(s) – very high perceived opportunity cost
  - Single founder – emotionally challenging journey
  - High-flying corporate executive – not foolish enough, thinks he knows it all
  - Lack of focus on tech or ability to think commercial – won't scale

Other considerations – Market size and dilution issues

- Market size: total revenue you can make by doing this kind of business
  - Revenue accrued to you counts here, not the total that passes through you
  - Size of market determines the size of exit.

- Dilution: Number of rounds are a function of what kind of exit you can expect from the company
  - For a $200m exit, almost impossible to get there in 5-7 years without raising about $25-50m
  - Helps if there are deeper pocket investors at the onset

Part 3: Life of an Entrepreneur

The Struggle

The Struggle is when you wonder why you started the company in the first place.

The Struggle is when people ask you why you don't quit, and you don't know the answer.

The Struggle is when your employees think you are lying, and you think they may be right.

The Struggle is when food loses its taste.

The Struggle is when you don't believe you should be CEO of your company. The Struggle is when you know that you are in over your head and you know that you cannot be replaced. The Struggle is when everybody thinks you are an idiot, but nobody will fire you. The Struggle is where self- doubt becomes self-hatred.

The Struggle is when you are having a conversation with someone and you can't hear a word that they are saying because all you can hear is The Struggle.

The Struggle is when you want the pain to stop. The Struggle is unhappiness.

The Struggle is when you go on vacation to feel better and you feel worse.

The Struggle is when you are surrounded by people and you are all alone. The Struggle has no mercy.

The Struggle, continued

The Struggle is the land of broken promises and crushed dreams. The Struggle is a cold sweat. The Struggle is where your guts boil so much that you feel like you are going to spit blood.

The Struggle is not failure, but it causes failure. Especially if you are weak. Always if you are weak.
Most people are not strong enough.Every great entrepreneur from Steve Jobs to Mark Zuckerberg went through The Struggle and struggle they did, so you are not alone. But that does not mean that you will make it. You may not make it. That is why it is The Struggle.

The Struggle is where greatness comes from.

~ Ben Horowitz

Uncertainty and Ambiguity

- Every other „job" a founder has done in past has clarity available. Suddenly, you are forced to build a plane as you are coming down from sky.

- *Ambiguity:* There are always two or more choices available, further it remains unclear what will
be the outcome till you have picked one or the other.

- *Uncertainty*: Even if you miraculously made the right choice, the impact of it on your life and business remains largely determined by external factors, many of those you are simply unaware let alone control.

- Entrepreneurial gut is the most important element in the success of an enterprise.
  - Somehow our hearts *know* what the right choice should be.
  - At the same time, it is very easy to fall into a trap of self-loathing and guilt
  - Consequently, 6/10 entrepreneurs are in depression at any given time.
  Effect on relationships and health are also acute.

Dealing with Ambiguity and Uncertainty

- *Self Selection:* As the hardened entrepreneurs would admit, you struggle for 1000 days and then you get used to it. It takes this long to get this journey become a part of you. Others simply quit.
- *Co-founders:* Single founder journeys are incredibly hard. Having partners reduces the pain and increases the joy.
- *Community*: Peer group is the best support system an entrepreneur can get. All their peers from past are not able to relate to them. Entrepreneurs also help each other with knowledge.
- *Mentorship*: Those who have been through the journey often want to give back in terms of helping younger folks avoid the obvious mistakes.
- *Advisors and investors*: One of the key roles that investor play is to keep the founders grounded into their true potential. Some investors are lovingly called „co-founders" for this reason.14

Life as an Entrepreneur

- Life as an entrepreneur is hard. But, after a few years the founders start loving the struggle and they will rather have nothing else.

- They know that the days of success will be full of rejuvenation and hope but will be far fewer. Most of their mental journey is about coming to terms with the journey. Top entrepreneurs in our portfolio see themselves doing their business forever.

- Through the journey, they know that most relationships are transactional. They are happy that at least some of those precipitated in a lifelong friendship.

- A lot has to do with personal maturity. Typically this won"t happen in 20s. Family, kids, lifestyle etc has to align with the future of the business.

- In effect, life as an entrepreneur is a *lifestyle* as an entrepreneur.

Thank You