Start-Up Financing 101

Dr Adrian Vanzyl

adrian@ardentcap.com

About Ardent Capital

We are an Operator Venture Capital Firm

- Headquartered in Bangkok, offices in Singapore and Jakarta
- Not a traditional fund – no carry, no management fee, no fixed size or lifespan
- Focus on ecommerce companies, B2C and B2B platforms supporting commerce
- Invest only across Southeast Asia
- Where the management team is in SEA
- Where the primary customer base is in SEA
- Venture side of Ardent
  - Seed and early stage
  - 7 investments so far, including E27
- Labs side of Ardent
  - We build a company inside of Ardent
  - aCommerce as example – full backend logistics and fulfillment, 4 countries, 250 staff
- Founded by the entrepreneurs behind Ensogo (sold to LivingSocial), Admax (sold to Komli) and NewmediaEdge (sold to STW)
- Investors include founding team, plus Sinarmas (Indonesia), Recruit.co.jp and GMO-vp.com (Japan), Siemervc.com (US), and several regional angels.

About Adrian Vanzyl

CEO and co-founder of Ardent

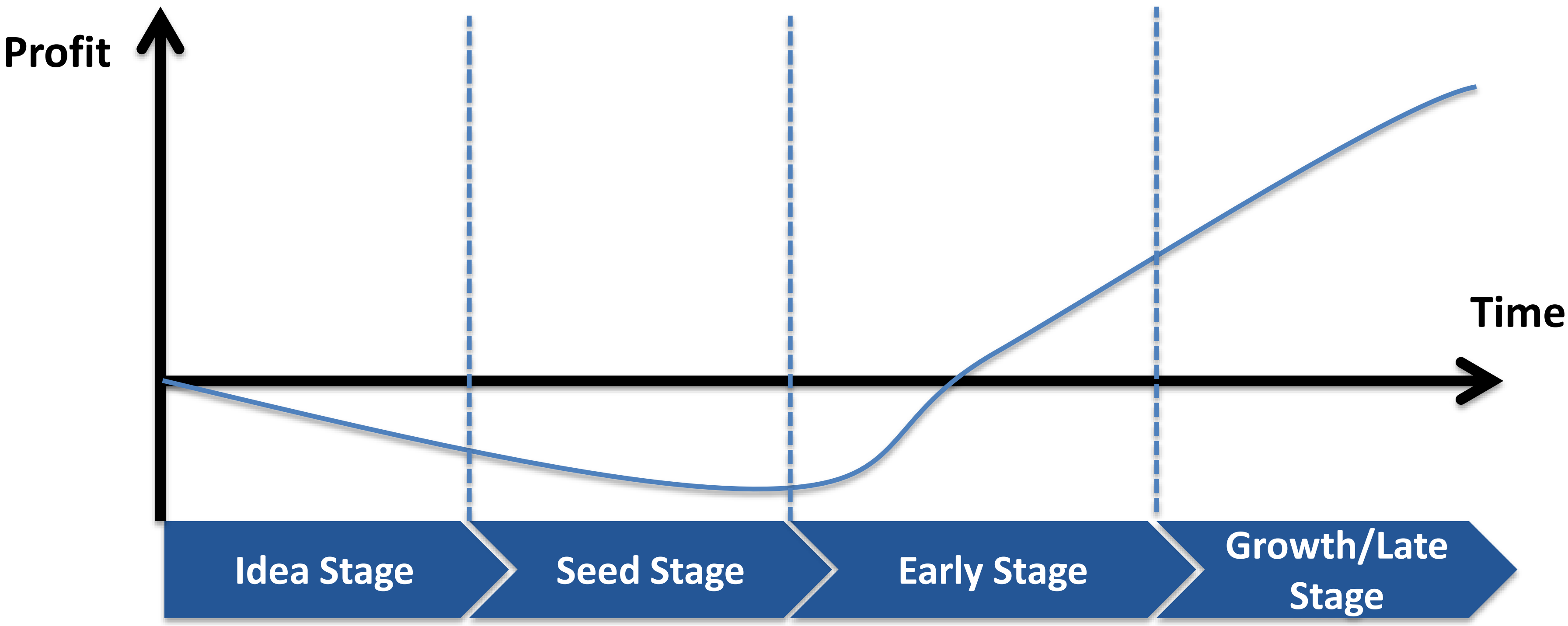
- Educated in Australia
- AU 1995, CTO of Sausage Software (HotDog), IPO on ASX
- USA 1997, CTO of LookSmart, IPO on Nasdaq
- USA 1999, VP Bizdev LinkExhange, sold to Microsoft
- USA 2000 onwards, CTO Blumberg Capital, $100M early stage VC in SF
  - CEO of two portfolio companies
  - Over 70 investments, including Hootsuite, Nutanix
- Thailand, end 2011 onwards, CEO Ardent Capital

- MD by training (Monash University, MB BS)

- I love technology, the internet, entrepreneurs, investing and building stuff
- Have personally invested in about 30 companies

Start-up Financing Stages

Start-up needs money at different stage to grow the business



Bootstrapped or less than **$20K** raised

Less than **$500k** raised

More than **$500k** raised

***Size of investment in tech startups in Indonesia**

How to Fund Your Start-Up?

There are essentially two different types of business financing

Debt

$$ @ t = T + Interest

Startup → Lender

Lender → Startup

$$ @ t = 0

Startup succeeds

Startup fails

Startup pays $$ + interest to lender

"Less risks less returns"

Lenders are <u>less</u> involved in your company

Equity

%Ownership e.g. stock

Startup → Investor

Investor → Startup

$$

Startup succeeds → **Investors make $$$$**

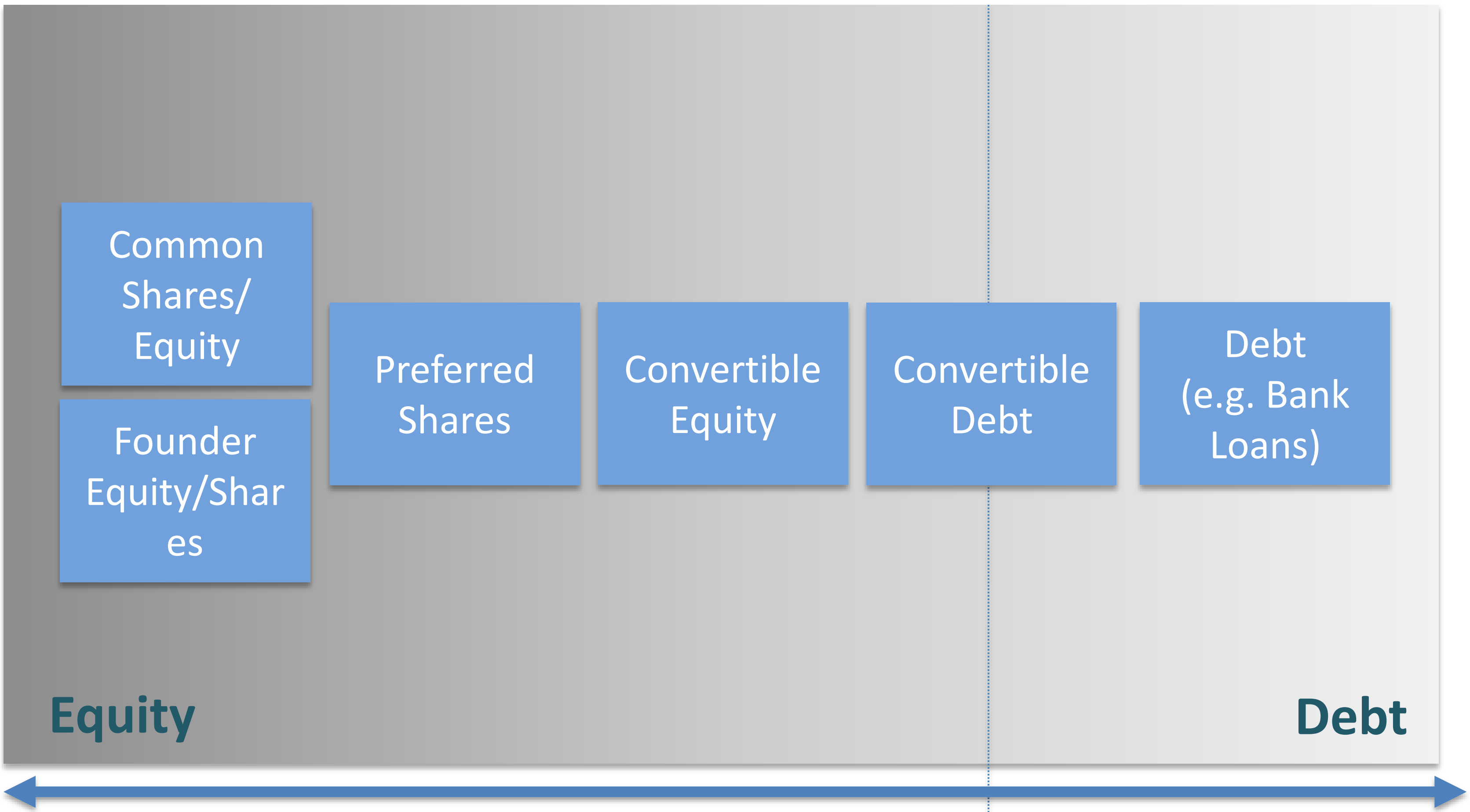
Startup fails → **Investors loses money**

"High risks High returns"

Investors are <u>more</u> involved in your company

Which Type of Financing is Best?

There are many types of investment vehicles depending on your objectives and the stages which your start-up is in



Common Stock/Common Shares

Common Stock is a form of equity ownership and gives the right to its owner to share in the profits of the company

- Common shares ≠ Founder Shares or Preferred shares
- Also known as **"ordinary shares"**
- Can be **"voting"** or **"non-voting"**
  - A ***voting share*** is a share of stock with the right to vote on certain corporate policies
  - Complex cap table situations (hundred small shareholders is a problem)

- **Common stockholders** have a **residual claim** to the income and assets of the business but **after bondholders, preferred shareholders and other debt holders** have been paid in full in the **event of liquidation**

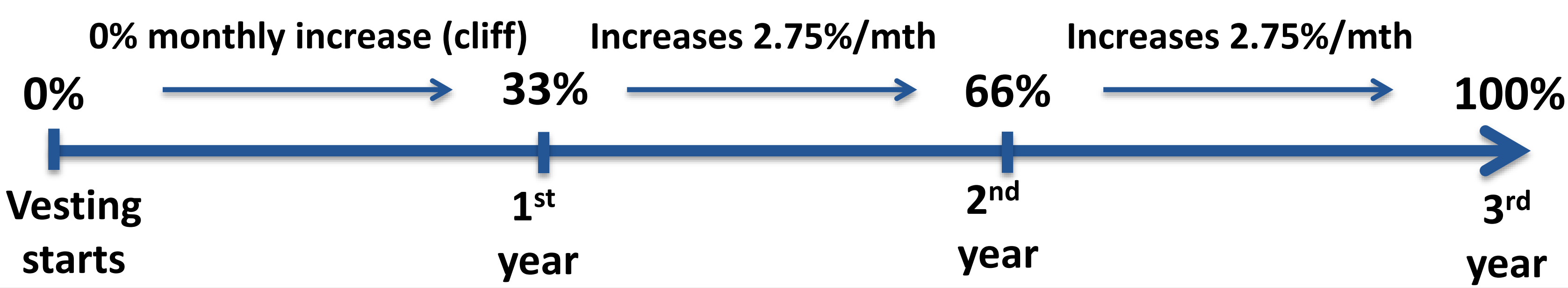
Startup Liquidation → $$$ → Bondholders, preferred shareholders and other debt holders → $ → Common shareholders

Founder Equity/ Founder Shares

Even before seeking outside financing, founders must agree on how to split initial ownership

- **Founder Equity/Shares** are **simply common stock**
- **Vesting schedule**
  - Usually follow a vesting schedule but may start vesting before the issuance of founders' stock or even prior to the date of incorporation
  - This vesting is balanced by investors' desire to keep the founders committed to the company over the long term and reduce the risk of founders leaving early
  - **Typical structure:** 3-4 year period, in equal monthly increments.

Example : 3-year monthly vesting with 1-year cliff



Employee Stock Options

- **Option to buy stock**, not an actual share
- Employees get options **"for free"**
- Critical to **motivate and retain staff**
- **Cliff** – typically one year
- **Vesting schedule** – 3 to 4 years
- **15-30% of the company (US)** and varies depending on region
- **Separate from Founders shares**

3 Components

- Strike price / Exercise / Acceleration on exit

Importance

- Can make your employees rich
- Critical for building the ecosystem

Preferred Shares

Venture capitalists and other early stage investors typically invest in startups through preferred shares

- **Class of stock** that provides certain **rights, privileges, and preferences to investors senior to those of common stockholders**
  - dividend payment preferences
  - liquidation preferences
  - redemption rights
  - voting rights

- In the **event of a sale of the business,**
  - Preferred equity holders **get paid** at least their money back **before the common shareholders** (downside protection)

Startup Liquidation → $$$ → Bondholders, preferred shareholders and other debt holders → $ → Common shareholders

Convertible Debt, or Convertible Note

WHAT IS IT?

- A ***type of debt*** that the holder can convert into a specified number of shares of ***common stock*** in the issuing company
- Specified at the time the loan is made **how and at what event** the **conversion** occurs (eg. revenue threshold, business milestone, etc.)
- Converts on a ***"Qualified Financing"***
- **Compensation** in the form of
  - Discount
  - Cap on the valuation to protect investors from a massive increase in valuation

WHY USE IT?

- ***Valuation***: Founders can raise funds without setting a valuation on a company. This is less dilutive if the company believes its equity will be worth more at a later date
- ***Speed***: Typically faster than raising a priced round from an institutional venture capital firm
- ***Lower transaction costs***: (mostly legal fees) when issuing debt vs. equity
- ***Control***: Founders retain majority of voting stock in the company

Convertible Debt: Example

SCENARIO: Supposed an investor invests $100,000 in a startup as a convertible debt,
Note terms: 20% discount and automatic conversion after a qualified financing of $1M.

BENEFIT TO CONVERTIBLE DEBT HOLDERS	
Discount: Amount of reduction in price the convertible debt holders will get when they convert in the next round (usually 20% - 25%) **In this case**: Assuming the shares were priced at $1.00, the investor can convert the $100,000 debt to shares at the discount rate of $.80 each (20% discount). That gives the initial investor 125,000 shares for the price of $100,000	**Cap**: It protects investors by putting a ceiling on the conversion price and permits investors to share in any significant increase in the value of the startup subsequent their investment, setting the limit before the shares get diluted **In this case**: If the pre-money cap was $5M, convertible debt holders would still get a discount of 20% up to that amount. If the startup raised at a valuation over $5M, then the investor will convert at $5M no matter what the actual valuation is

Selling Founders Shares

Buy out some of the Founders' holding

- An investor buys shares directly from a founder
- The money does NOT go into the company
- It only goes to the founder

Founder positives

- Gets some money out
- Reduces day to day stress (can I afford to pay my rent)

Company negatives

- Money doesn't go into company to help it grow
- If too much can demotivate the Founder

The different stages of equity financing

A typical start up go through multiple rounds of financing, but the number and type of stages may change based on start up performance and market conditions

Idea Stage	Seed Stage	Early Stage Round	Growth/ Late Stage
• Bootstrapping • Angels • Friends & Family • Incubators • Accelerators	• Angel Investors • Incubators • Accelerators • Seed Funds	• Institutional Funding – Series A	• Institutional Funding – Series B – Series C • IPO

Why the different stages of financing?

Entrepreneurs often raise capital in multiple rounds of financing so that they can take advantage of higher pre-money valuations at each subsequent round

- Before each equity financing round, there is a valuation of the company
- Each round is priced independently and involves a new term sheet specifying the characteristics of the investment

Post Money Valuation **=** Pre Money Valuation **+** Investment

Why the different stages of financing?

Angel Stage

Price/Share: $1

Valuation: $500k

Shareholder	Investment	# of Shares	% Ownership
Founder	-	400k	80%
Angel #1	$100,000	100k	20%
TOTAL	**$100,000**	**500k**	

Series A

Price/Share: $2

Pre-Money Valuation: $1mm

Post-Money Valuation: $2.2mm

Shareholder	Investment	# of Shares	% Ownership
Founder	-	400k	36.4%
Angel #1	$200,000	200k	18.2%
VC #1	$1.0mm	500k	45.4%
TOTAL	**$1.2mm**	**1.1mm**	

Shareholders' Agreement

A shareholders' agreement (or SHA) is an arrangement among the company's shareholders describing how the company should be operated and the shareholders' rights and obligations

- **Key provisions** include
  - Board of Director Composition/ Appointment
  - Right of First Refusal
  - Veto Rights
  - Pre-Emptive Rights
  - Drag Along/ Tag Along Rights
  - Liquidation Preference & Participation Rights

- These **provisions with investors** are **described** in the **term sheet** (funding agreement between the company and the investor)

Term Sheet Highlights

Clause	What it means	Why it's there
Board of Director Composition and Appointment	Investor can demand the right to appoint/remove its representation and independent observer (different legal responsibility from other board members) to the board <u>Typical board composition</u> • Odd number of members • Chairman • Example – 2 insiders (incl. CEO), 2 investors, 1 independent	Sharing control of the company
Right of First Refusal	Investor has the right to acquire shares before shares are transferred to a third party <u>Example:</u> if Shareholder A wishes to sell shares to a third party, but Shareholder B has the right of first refusal, B has the right to acquire shares before A can transfer shares to the third party. If B decides to acquire all the shares, then the third party will not even have the chance to acquire any shares from A *This makes negotiating with a new buyer complicated, as they know at the end of it all, they may still not get their shares	This is to avoid unwanted new shareholders (e.g. a competitor) from owning part of the company

Term Sheet Highlights

Clause	What it means	Why it's there
Veto Rights	Investors can negotiate specific veto rights on (i) Financial Interests/Affairs • Capital expenditure exceeding limit • IPO decision • Sale, transfer, lease, mortgage, or pledge of company assets of a value over a defined amount • Change in the nature/scope of the company • Any increase, reduction or alteration to the issued share capital of the company • The winding up, dissolution or liquidation of the company, including any filings related to the foregoing (ii) Corporate Governance • The appointment, remuneration and dismissal of any director and the auditors of the company • The appointment, terms and dismissal of any member of the management team and key employees	Investors can have decision-making over certain issues deemed important to them

Term sheet highlights

Clause	What it means	Why it's there
Pre-Emptive Rights	Existing shareholders have the rights to participate in later financial round up to their pro rata shareholding	(1) To prevent existing shareholders from a dilution (2) To help existing shareholders to maintain control
Drag Along Rights	If the majority shareholders decide to sell the company, all shareholders must sell	(1) Easier to sell company should the majority wants to exit (2) Prevent "Hold-Up"
Tag Along Rights	If the majority shareholders decide to sell the company, the minority shareholders have the right to join the exit	(1) To protect the minority shareholders (Minority shareholders get the same terms and conditions as would apply to the majority shareholders)

Term sheet highlight: Liquidation Preference

The liquidation preference determines how the pie is shared in a liquidity event

- Liquidation Preference specifies ***how money is returned to a particular series of the company's stock ahead of other series of stock***

<u>Example</u>

- ***Liquidation Preference:*** *In the event of any liquidation or winding up of the Company, the holders of the Series A Preferred shall be entitled to receive in preference to the holders of the Common Stock a per share amount equal to [x] the Original Purchase Price plus any declared but unpaid dividends (the Liquidation Preference)*
- In this case, a certain multiple (x) of the original investment per share is returned to the investor before the common stock receives any consideration

Participation Rights

After the payment of the liquidation preference, the next thing to consider is whether or not the investor shares are participating

- **Fully-Participating** stock will share in the sale proceeds on a pro rata basis with common after payment of the liquidation preference
- **Capped Participation** indicates that the stock will share in the sale proceeds on a pro rata basis until a certain multiple return is reached
- **Non-Participating** This liquidation preference is most favorable to the company as the stock will not share in the sale proceeds beyond the payment of the liquidation preference

Liquidation Preferences in Different Scenarios

Depending on the sale price, liquidation preference can lead to drastically different outcomes for founders

- Assuming that both classes of preferred (Series A & B) are straight preferred with no multiple or dividends with Series B senior to the Series A

FOUNDER	SERIES A ($1M)	SERIES B ($4M)
Originally owned 45.4% Total Shares = 1,000,000	Originally owned 18.2% Total Shares = 400,000 @ $2.5/share	Originally owned 36.4% Total Shares = 800,000 @ $5/share
		
GET RESIDUAL AMOUNT	**GET SECOND CLAIM**	**GET FIRST CLAIM**

Scenario 1: Low Exits at Sale Price = $3M

If the sale price is low enough, founders can sell the company and not get the fully diluted ownership percentage of the proceeds because some or all of the preferred shareholders will choose to take their liquidation preference instead of their percentage of the company. In this case, **because of Liquidity Preference, Series B will get claim of the 100% of total proceeds.**

FOUNDER	SERIES A ($1M)	SERIES B ($4M)
		
		Get 100% of Total Proceeds = $3M

Scenario 1: Low Exits at Sale Price = $5.5M

In this case, **because of Liquidity Preference Series B will get first claim of the total proceeds, Series A will get second claim, and Founder will get the residual amount.**

FOUNDER	SERIES A ($1M)	SERIES B ($4M)
		
Total Proceeds = **$500k** 9.1% of Total Proceeds (45.4% of Pre-Sale Ownership)	Total Proceeds = **$1M** 18.2% of Total Proceeds (18.2% of Pre-Sale Ownership)	Total Proceeds = **$4M** 72.2% of Total Proceeds (36.4% of Pre-Sale Ownership)

Scenario 2: High Exits at Sale Price = $22M

In the case of a high exit, **preferred shareholders may choose not to exercise their liquidity preference and instead take their percentage of the company**

FOUNDER	SERIES A ($1M)	SERIES B ($4M)
		
Total Proceeds = **$9.988M**	Total Proceeds = **$4.004M**	Total Proceeds = **$8.008M**
45.4% of Total Proceeds	18.2% of Total Proceeds	36.4% of Total Proceeds
45.4% of Pre-Sale Ownership	18.2% of Pre-Sale Ownership	36.4% of Pre-Sale Ownership

Start Up Funding Landscape

Idea Stage	Seed Stage	Early Stage (Series A)	Growth/ Late Stage
Angels **Friends & Family** **Incubators** • JFDI • FF&F • Self fund	**Seed Funds** • **Ardent Capital** • Golden Gate Ventures • Jungle Ventures • Crystal Horse • NRF	• **Ardent Capital** • CyberAgent • SingTel Innov8 • Recruit • Rakuten • Gree	• SingTel • Tiger Global • Sequoia • Macquarie

Why Venture Capital? Why Ardent Capital?

Funding Benefits from Venture Capital		Why Ardent Capital?
Non-debt investment in the form of cash that startup needs	→	Invested in **seed and early stage** startups with **no carry or management fee, no fixed size or lifespan**. 7 investments so far.
Expertise and advice	→	Founded by the **entrepreneurs behind successful startups** including Ensogo, Admax and NewmediaEdge with cumulative value > $110M to date
Network and connections	→	Investors include **founding team, plus investors across the globe** including Japan, US, Australia, Indonesia, Singapore, Malaysia, Thailand

THANK YOU

adrian@ardentcap.com

APPENDIX

Liquidation Preferences in Different Scenarios

Depending on the sale price, liquidation preference can lead to drastically different outcomes for founders

- Assuming that both classes of preferred (Series A & B) are straight preferred with no multiple or dividends with Series B senior to the Series A

FOUNDER

Originally owned 45.4%
Total Shares = 1,000,000

VC 1

Originally owned 27.3%
Total Shares = 600,000
Total Cost $2M

VC 2

Originally owned 27.3%
Total Shares = 600,000
Total Cost $3M

400,000 shares x $2.5/share = $1M

200,000 shares x $5/share = $1M

600,000 shares x $5/share = $3M

SERIES A

Originally owned 18.2%
Total Cost = $1M

SERIES B

Originally owned 36.4%
Total Shares = 800,000
Total Cost = $4M

Scenario 1: Low Exits at Sale Price = $3M

If the sale price is low enough, founders can sell the company and not get the fully diluted ownership percentage of the proceeds because some or all of the preferred shareholders will choose to take their liquidation preference instead of their percentage of the company. In this case, **because of Liquidity Preference, Series B will get claim of the 100% of total proceeds.**

FOUNDER

0% in Series B
Total Proceeds = $0
45.4% of Pre-Sale Ownership

VC 1

25% in Series B
Total Proceeds = $750k
27.3% of Pre-Sale Ownership

VC 2

75% in Series B
Total Proceeds = $2.25M
27.3% of Pre-Sale Ownership

SERIES A

SERIES B

100% of Total Proceeds
although
36.4% of Pre-Sale Ownership
Total Proceeds = $3M

Scenario 1: Low Exits at Sale Price = $5.5M

In this case, **because of Liquidity Preference Series B will get first claim of the total proceeds, Series A will get second claim, and Founder will get the residual amount.**

FOUNDER

Total Proceeds = $500k
9.1% of Total Proceeds
although
45.4% of Pre-Sale Ownership

VC 1

Total Proceeds = $2M
36.4% of Total Proceed
although
27.3% of Pre-Sale Ownership

100% of $1M = $1M

25% of $4M= $1M

VC 2

Total Proceeds = $3M
54.5% of Total Proceed
although
27.3% of Pre-Sale Ownership

75% of $4M= $3M

SERIES A

Total Proceeds = $1M
18.2% of Total Proceeds
(18.2% of Pre-Sale Ownership)

SERIES B

Total Proceeds = $4M
72.2% of Total Proceeds
(36.4% of Pre-Sale Ownership)

Scenario 2: High Exits at Sale Price = $22M

In the case of a high exit, **preferred shareholders may choose not to exercise their liquidity preference and instead take their percentage of the company**

FOUNDER

Total Proceeds = $9.988M
45.4% of Total Proceeds
45.4% of Pre-Sale Ownership

VC 1

Total Proceeds = $6.006M
27.3% of Total Proceeds
27.3% of Pre-Sale Ownership

VC 2

Total Proceeds = $6.006M
27.3% of Total Proceeds
27.3% of Pre-Sale Ownership

100% of $4.004 = $4.004M

25% of $8.008M= $2.002M

75% of $8.008M= $6.006M

SERIES A

Total Proceeds = $4.004M
18.2% of Total Proceeds
18.2% of Pre-Sale Ownership

SERIES B

Total Proceeds = $8.008M
36.4% of Total Proceeds
36.4% of Pre-Sale Ownership

CONFIDENTIAL | © 2013 Ardent Capital Singapore | Thailand | Indonesia | Philippines | Malaysia | Vietnam ARDENTCAPITAL