Central European Startup Guide

by

Andrej Kiska Jr. of Credo Ventures

To the teams of Credo Ventures and Benson Oak as well as all the startups for teaching me all I know, Irma for giving me the idea for this Guide and Geri for making it readable.

Section I. Introduction

Six years. Thousands of business plans. Yet the same questions.

When I first started investing in technology companies in Central Europe six years ago, I didn't even know that the word "startup" existed. Or "coworking space." Or "accelerator." Or "unicorn." Sure, we were the first backers of AVG Technologies (one of very few companies from Central Europe that went public on the New York Stock Exchange and surpassed a billion dollar valuation), but nobody told us we should call AVG a startup or a unicorn.

A lot has changed since then, even in our region. Sometimes it feels like everyone has a startup. There are plenty of coworking spaces, accelerators, blogs, and mentors. Even success stories show up every now and then.

Yet when I listen to entrepreneurs pitch today, I can't help but notice some sort of . . . uncertainty. Yes, everyone in the conversation throws around the unicorns, startups, and non-participating liquidation preferences. But how many really know how to differentiate between a startup and a small and medium-sized business (SMB)? Or when to ask for a seed investment and from whom, or how to negotiate a term sheet? Our startup community seems full of buzzwords imported mainly from Silicon Valley, but do we really know what those buzzwords mean and how to apply them to the realities of Central Europe?

Thanks to all the bloggers, entrepreneurs, and investors willing to educate our ecosystem. I have a biweekly blog as well, and I fully understand how difficult and consuming such work is. The goal of this Guide is to support that effort: I have compiled a few of my blogs to help entrepreneurs find a lot of resources in one physical place that should aid them in navigating the murky waters of the Central European startup ecosystem.

After clearing up what a startup actually is, we will look at the startup investment cycle, describing what angel, seed, and Series A investments in our region look like. The third section will then give tips on how to approach an investor and negotiate a term sheet without losing all your hair, your startup, or both. The concluding section will tackle one of the least understood and most complex topics in managing a startup: employee motivation and equity.

This book has no ambition of becoming a complete guide to the startup ecosystem. I've only tried to address a few topics that I've noticed entrepreneurs continuously struggle with over the years. There are many more to cover, and I hope to do so over the upcoming years. If you feel something is missing from the Guide, or you disagree with me on any points, please get in touch at kiska@credoventures.com. After all, the investors should learn as much from the startups as the startups learn from the investors.

Andrej Kiska, Partner at Credo Ventures

1. What is a Startup?

"I am sick and tired of the word 'startup'. It seems like everyone and their mother has a startup today. I might even start calling the grocery store next door a food startup."

This is a quote I have been running into in one form or another increasingly often in the past six years. The quote is part of a growing phenomenon (not only) in Central Europe; let's call it startup hype.

I don't know whether or not we are experiencing startup hype. I wouldn't even know how to define it, measure it or prove its presence or absence, and I am not sure it is worth anyone's time to do so. But if I were to side with the claim that our region is experiencing startup hype, I would argue that there is a paradox: We are experiencing startup hype despite the fact that there are very few actual startups. And part of the reason for such a paradox is the ambiguity surrounding the definition of a startup.

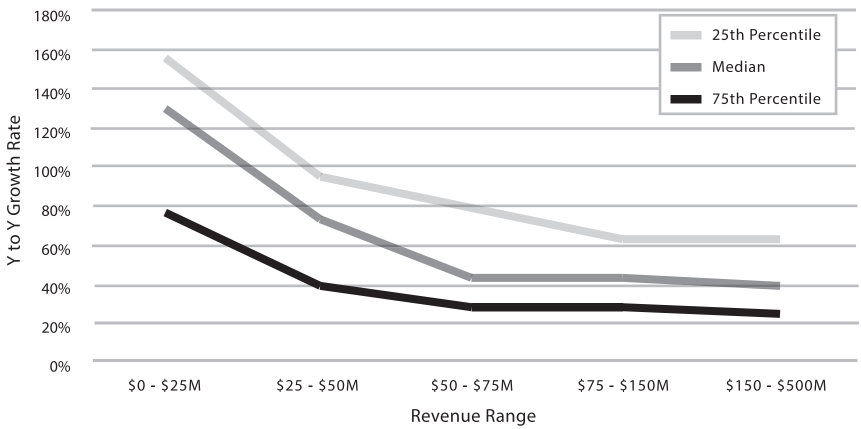
In order to dig deeper into the intricacies of the startup world in the chapters below, I thought it would be useful to first discuss what a startup actually is and just how many of the companies we see at startup events today really fulfill that criteria.

Definition of a Startup

Defining a startup is a risky affair that I am not going to undertake myself. Instead, I am going to steal a definition from Y Combinator co-founder Paul Graham's widely circulated article on growth.[1] Graham defines a startup as a "company designed to grow fast." It is not necessarily just a company that grows fast, since most startups fail, but a company that makes an explicit commitment to grow fast. Such a commitment makes a huge difference in how founders approach building and managing their company, and accents a mindset rather than a factual description—a mindset we at Credo Ventures want to back with an investment.

Of course, the natural question is, how fast is fast? At Y Combinator, Graham considers good growth 5–7% a week and exceptional growth 10%. These numbers ideally reflect revenue, while the next best measure is active users. A typical company at Y Combinator makes about $1,000 per week in revenue at the beginning of the program.

The natural follow-on question is, for what period of time? The length of the exponential growth naturally defines the startup's success. Graham makes an example of a company that grows from $1,000 by 5% weekly for 4 years (and thus ends up making $25 MM a month in revenue). Below is a great chart from Jules Maltz showing what kind of growth successful startups experience, especially in more mature stages.[2]



So how many startups does our region really have?

My point is not to argue whether 2%, 5%, or 10% is the right weekly growth, nor is it to argue that startups should grow by such a rate for 2, 4, or 8 years. The point is that if we look at the number of companies in our region that are at least attempting to generate such growth numbers, or are even thinking of reaching something like $25 MM in monthly revenue (real company net revenue, not value of processed transactions) in 4 or even 8 years, we could cross out the vast majority of companies that call themselves startups. I would call them small- to medium-sized businesses. There's the end of the startup hype.

Surely a lot of our entrepreneurs will say that such growth is impossible to achieve in a single European country. And, yes, the second point is that it is very hard. One could indeed make the case that it is harder here than in the United States, China, or India. But it's not impossible. At Benson Oak Capital, I have seen our portfolio company AVG grow from low single-digit MM in annual revenue in 2003 to USD 180 MM in 2009. From Brno. Czech Republic. I suppose revenue CAGR nearing 100% is still pretty good given the company was at a much later stage than a typical YC startup. AVG's 2009 revenue had doubled by 2012 and has hovered around a valuation of USD 1 Bln for most of 2014.

The reason that building startups is harder for us in Central Europe is based on our small domestic markets: Companies in China or India can be startups even with a "local" business idea because their definition of local has hundreds of millions of potential users. I bow in front of those entrepreneurs who can achieve startup-like growth for a prolonged period of time with a single-country focus in Europe, especially Central Europe. They are truly masters of business execution. But based on Graham's logic, I would argue that if we want to run a startup and achieve startup-like growth in our region, we would have an easier time starting with the premise that we want to build a global company and, thus, starting businesses that stand the test of global competition.

Some globally celebrated entrepreneurs like Richard Branson made their first successes with local businesses such as "CD shops" or virtual mobile operators. But Branson executed them well in a market much bigger than our region's. He might even have experienced the kind of growth Graham expects to see in a startup. And those "local" businesses made him a fortune big enough to finance his own space program. I have serious doubts that a local business in Europe will give us a chance to finance our own space program (most likely not even a chance to go through someone else's program). Maybe I am wrong. But for all those who want to leave their own mark in the universe, I think you have better odds with sticking to a global startup. And for those who don't, that's fine, there is nothing wrong with a small- to medium-sized business—heck, even a big-sized business. Just don't call your company a startup; you'll help us avoid the startup hype.

Now that we have defined what a startup is, we can move on to analyzing the unnecessarily mystified process a startup will inadvertently face—the startup investment cycle.

Section II.
The Startup Investment Cycle

2. Investing in Startups—How Does It Work?

"So I think I figured out the next Facebook. Now where do I get money to build it? And heck, how do I get money out of it?"

This is an introductory chapter to the section that will analyze the startup investment cycle: While this first chapter discusses what the cycle looks like in mature markets such as the Silicon Valley, the next chapter will analyze specifics of the cycle in Central Europe. Subsequent pieces will dig deeper into each phase, examine valuations and average investment sizes, and explain the mindset of local investors, using Credo Ventures as a case study.

Remember that we are analyzing the investment cycle of high-tech startups, not small- and medium-sized businesses.

The History and Evolution of the Investment Cycle

A lot has changed in the startup investment cycle since the days of the first high-tech VC investment that was made in 1957—the Digital Equipment Corporation (DEC). Companies like DEC or Tandem had to manufacture their own products, which meant that product prototyping required, for example, building a factory. Considering that a startup also required a direct sales force, field engineers, or professional services, it is hardly surprising that the payroll included 50–100 employees before having a first customer. Back in the day, establishing a startup meant spending massive amounts of money and undertaking huge risks before having any functional version of the product.

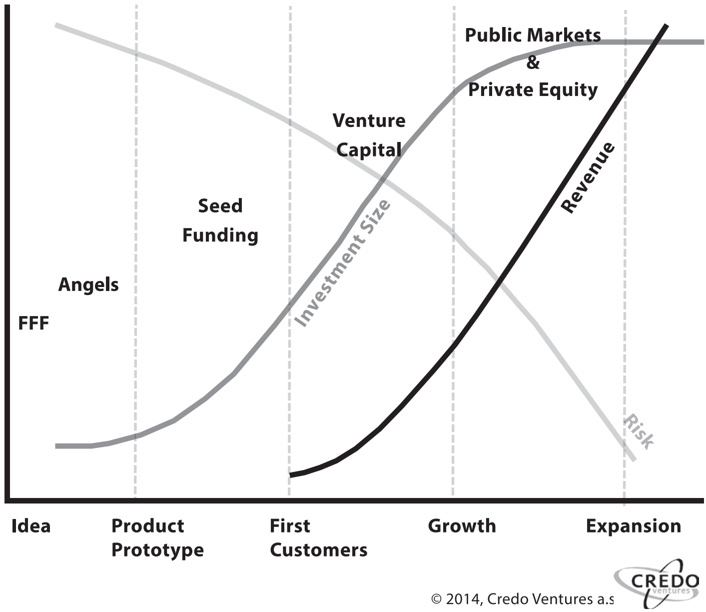
Luckily for all of us (maybe aside from factory builders), almost all startups today are able to divide this early stage investment cycle into different phases. Thanks to modern software and the power of outsourcing, startups can start prototyping their product within minutes with almost no capital. It still takes lots of money and massive risk to build a successful company (according to CrunchBase,[3] the average successful startup with an exit since 2007 has raised USD 41 MM, with successful defined as exiting for an average of USD 155 MM or IPO-ing at USD 467.9 MM), but the cost of developing and testing the initial product has shrunk dramatically.

Why Does an Investment Cycle Exist?

Today's investment cycle very much copies the company development cycle: First, there are founders who come up with an idea. Then, they turn the idea into a product prototype to test whether there would be any interest for it in the market. Building upon initial feedback from the first beta users, founders fine-tune the product to come up with the first version to be released to the public. If the product gains significant interest, founders hire more people to help get the product to as many people as possible. As competition and alternative products emerge, the company finds itself under pressure to innovate again and, thus, raises even more money to help the company drive innovation and buy out competition, and so certain phases of the cycle start repeating themselves.

Each phase in a company's lifecycle is associated with a different problem set and different funding requirements. Furthermore, as the company advances in the cycle, its risk profile decreases. In mature financing markets, there are investment professionals who focus specifically on each development phase. In Central Europe, we have a few VC/PE firms that try to address some of the stages, but we are far from having all bases covered well.

The graph below is basically a graphic form of the investment cycle:



Please note that the graph is just an approximation serving explanatory purposes; the lines between different financing stages are often blurry, as is the investor focus (again, especially in Central Europe).

The Investment Cycle and Investor Role Overview

Angels & Family, Friends, and Fools (FFF): These are the guys who take by far the biggest risks, since they invest solely into the entrepreneur with an idea. FFFs are a bit of a separate category. We fundraise from them every time we ask for pocket money, and they don't expect much in return (in most cases). Angels, on the other hand, tend to be investment professionals who generally invest their own money with the goal of allowing the entrepreneur to build the first versions of the product. A good angel investor is a well-connected, wealthy individual who can offer operating expertise and his network of contacts. This investor class typically does not encumber the entrepreneur with any corporate governance typical for later-stage investors, such as a seat in the board of directors or lengthy due diligence processes.

Seed Funding: Seed funding is typically used to develop the product to a phase where it can be used by the general public (or at least early adopters, who can get over a few crashes and bugs here and there), and ideally secure a customer or two (a customer, as opposed to a user, is someone who actually pays for the product). Entrepreneurs operating in mature markets such as Silicon Valley or Israel have access to specialized seed funds, whose expertise typically focuses on product development and sourcing of technical co-founders. While I don't want to get into the intricacies of the CE region just yet, I will say that it is quite rare to see a professional seed fund in our region that can truly add the value needed for this phase of the company life cycle.

Venture Capital: The typical venture capital investment, also called Series A or B depending on the stage of the firm, is used to scale the company's business model: Having secured a couple of paying customers, the goal of the Series A investment is to build out the sales force and establish foreign offices to really get the product out onto the market. A good VC fund should, among other skills, have the network to (i) source the senior salespeople and (ii) open doors to flagship customers. A venture investment typically comes from larger institutional funds, so the entrepreneur must be prepared for a full-fledged set of corporate governance rights: Investors conduct lengthy due diligence, take a board seat, and secure a host of rights such as liquidation preferences or tag along/drag along rights (more on that in the term sheet chapters).

Private Equity & Public Markets: The company might be crushing it on an international scale, but it can still feel the need to expand more aggressively (often times via acquisitions of major competitors), or to actively innovate its product. It is also not uncommon for the original founders to want to move on to something new, thus seeking a way out of the company. The private equity funds, together with public markets, fulfill all these roles: They can provide large amounts of liquidity or, in some instances, even acquire up to a 100% stake in the firm.

It is a very rare feat and a great accomplishment for a company to navigate through the entire startup lifecycle. It is even more rare to see the founding entrepreneurs staying for the whole journey. In fact, I can think of only a handful of entrepreneurs in Central Europe who can say they managed a company from the idea phase all the way to an IPO. Nevertheless, going through just the first few phases can be a thrilling and, in some instances, very rewarding journey.

The next chapter in the series is going to look at the investment lifecycle through the lens of the Central European region: What are its specifics, who are the players, and what can you expect when you approach them?

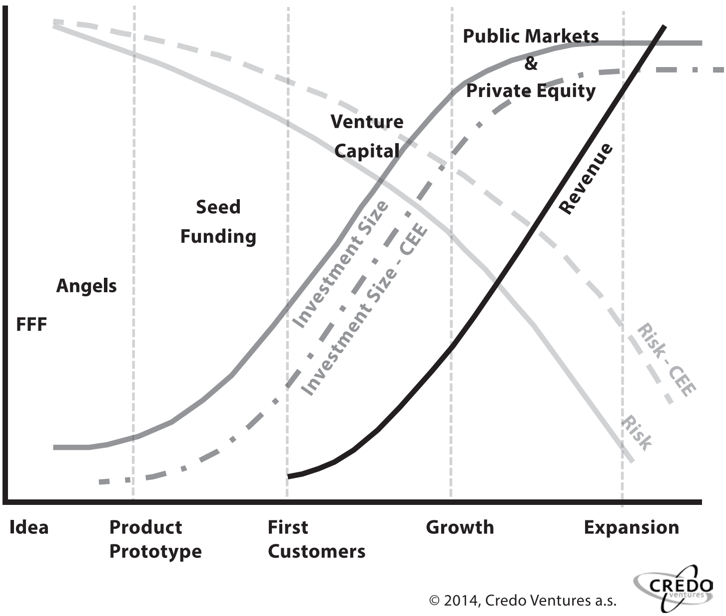
3. Fundraising in Central Europe

"It looks so easy on TechCrunch. It seems like everyone abroad is getting funded. But how do I get funding in Central Europe?"

Here is the good news: You don't have to go to Silicon Valley to get funded. Not even London or Berlin. There is plenty of capital to be found in CE—you just have to know where to look. And the bad news: If you know where to look and still can't get funding, that means your current idea/startup is just not good enough. And if you can't raise funds in Central Europe, the odds are very high that you won't in Berlin or London, either. It is better to fail fast and move on to something new.

The Investment Cycle in Central Europe

Perhaps the most frequently asked question I get related to fundraising is where to fundraise. Let's revisit the investment cycle graph for reference. I have included adjusted CE curves to illustrate some of the differences between the CE region and more established markets.



Angels & FFF: I guess we have to start with what is in my opinion the most complicated investor class to find for entrepreneurs, at least in the CE region. On one hand, everyone has family, friends, and fools. We can match Silicon Valley in that regard. But it is also part of our Central European nature to feel a bit awkward asking our family or friends for money (maybe because most of them don't have much to give). We certainly can't match Silicon Valley when it comes to professional angel investors. It's not that we don't have people who have enough money; it's that very few of them are open to investing in startups, and only a handful really have the risk tolerance required for an angel investment. Angels basically invest solely in founders and their vision, and even the vision might change form and shape a bunch of times before any product is created, if it ever will be. Therefore, they are taking by far the biggest risk of any investor class in the cycle.

My piece of advice is to avoid any angels that require financial models or lengthy business plans. How can someone at this stage ask for financial projections if the entrepreneur doesn't even know what the product will look like? Look for someone with whom you have good chemistry and who you believe can make critical business introductions for you. Also, this might be the only circumstance when gambling habits could be viewed as a positive personality trait.

Examples of great business angels in our region: Esther Dyson—in October 2011, she invested in Apiary right after she heard Jakub Nesetril's 15-minute presentation (the product at that stage was the presentation) and had a small chat with him afterwards. My regional favorites also include Eduard Mika, Hansi Hansmann, Karel Obluk, and Juraj Duris, but essentially I am a fan of everyone who invests in our local entrepreneurs and doesn't harass them as soon as something is not going according to plan.

It is undeniably hard to find good angel investors in the Central European region. Accelerators and incubators provide one route: Aside from offering angel money themselves, they also offer access to numerous mentors, many of whom are angel investors. Accelerators are beginning to jump out all over the place; just in the Czech Republic, we have StartupYard, Wayra, StartCube, and Node5, to name a few. Another way to identify smart money angel investors is to Google successful entrepreneurs from the field that your startup operates in and to try to approach them (an introduction from your network works a lot better than a cold call). Don't forget to utilize other online sources such as AngelList or Seed-DB.

Another emerging phenomenon is the EU and government money, which is primarily aimed at seed investments, but, sometimes, due to lack of investment opportunities, crosses over to angel investments as well. This trend varies country by country. Currently there is an abundance of such capital in Slovakia, while the first wave is already finishing in Hungary. The quality of such investors varies case by case and by implementation in each country (e.g., in Slovakia a lot of that money is handled by investment professionals or former entrepreneurs, while in Hungary you find a lot of EU funds with no experience in startup investing).

<u>Seed Funds</u>: The grass gets greener as we start mitigating some of the super early stage risk. I guess most of us Central European investors are still a bit cowardly.

There is a sizeable amount of seed money available in our region, also thanks to the above-mentioned deep pockets of the European Union.

Looking solely at Central Europe, we don't have too many seed funds with private institutional investors. There are foreign funds, which are very active in Central Europe, including Point 9 Capital and Index Ventures' seed fund. Credo Ventures has also allocated part of its fund to seed investments, so now even companies at the pre-product phase get access to our 30+ investors, including Avast or AVG Technologies and our fund managers. Speedinvest is also doing a great job on that front, gradually expanding its coverage from Austria to other Central European countries as well.

As discussed in the previous chapter, I believe that the key criteria (aside from the ever-present and super important chemistry) for choosing a seed investor are adding the most value to your product, sourcing crucial technical hires, and opening doors to first trial customers. These are the key issues that a startup faces during the seed phase.

Venture Capital: The grass might even get some blooming flowers if the startup can secure first paying customers (Credo defines "first paying customers" as generating around USD 10,000 in monthly revenue). There are quite a few funds, either based in Central Europe or active in the region via offices abroad, that are able to make a Series A investment.

The game in Series A, B, and beyond is all about scaling your business model and driving revenue. Therefore, choose an investor who can, in your opinion, open doors to customers and help build out your sales force. One piece of advice on structuring a venture capital investment: Don't be afraid to invite multiple investors as co-investors in the round, especially if each can bring a unique skill set to the table. 2–3 seems like a manageable number; 5+ major investors in a round tend to do more harm than good in our experience. 7 out of Credo's 8 investments in the last two years included co-investors, and we are very happy to have them on board.

Both VC and seed funds have a fairly strong web presence, so it shouldn't be too hard to find relevant players. Nevertheless, if you are looking for advice on a specific fund or would like an introduction, drop me a line.

Public Markets & Private Equity: The grass is actually overgrown in this segment, especially when it comes to private equity. A few of the smaller shops have closed because there was simply too much capital available on the market. If you make it to this stage, don't worry about finding a private equity investment. It will usually find you.

The situation is a bit worse when it comes to public markets. I haven't heard about too many companies having the ambition to IPO in Prague, Vienna, Budapest, or Bratislava. Maybe Warsaw. I have heard of a couple of companies wanting to IPO on NASDAQ or NYSE, and to my knowledge only one from the Czech Republic or Slovakia actually made it: AVG Technologies.

So this is the Central European startup investment lifecycle in a nutshell. The next follow-on question after "where to find my investor" is typically one regarding valuations and investment sizes. And that's precisely what the next chapter is going to tackle.

4. Valuations and Investment Sizes

"So I think I figured out the next Facebook, and I even have an idea where to look for investors. But how do I figure out how much money I should raise and what valuation I should strive for?"

The Right Investment Size

The investment size is actually not that difficult to calculate in the early stages when you don't generate revenue: Just look at your expenses (which mostly consist of salaries) and estimate how long it will take to get through that stage. How long will it take to build the first prototype of my product? 3–6 months? And will it take 3 people getting paid 1,200 EUR each per month? So I should raise between 10 and 20k for the angel stage, plus a buffer. For seed investments, the logic is very similar. Credo's strategy is to give between 12 to 18 month run rate at this stage, so just estimate your costs for the next 12–18 months. Very strong startups can actually show promising traction earlier than that and are able to receive the Series A round less than a year after the seed investment with a comfortable level of cash still in the bank. For venture rounds, the amount gets trickier because you have to start projecting some revenue and the cost base begins to increase significantly. More on that in the chapter devoted to building a financial model.

The European Private Equity and Venture Capital Association publishes annual statistics that contain some hard data on early stage investing, including investment sizes. I recommend checking out its website.

Below are some of my estimates of the average investment round size based on deals I see mostly in Central Europe. They do not include hardware startups. The point of these numbers is not to be 100% correct (there are plenty of exceptions), but to give entrepreneurs a ballpark estimate as to what they can expect in our region in different stages of the startup investment lifecycle.

Angel, FFF, Accelerators—EUR 10–100k
Seed—EUR 50–500k
Series A—EUR 400k–3 MM
Series B & further–EUR 2.5 MM+

The fairly wide investment range, especially in the latter stages, is attributable to a host of factors: aggressiveness of expansion/desire to grow, sales/customer acquisition model (direct sales force vs. partnerships vs. marketing expenses, etc.), cost of making/updating/innovating the product, etc. The key is to be able to identify and plan your costs ahead of time. And don't forget to include a reasonable buffer in case things go south. Cash is king, and if you run out of it, the game is over.

You must be delicate when including a buffer in your numbers: On the one hand, if they are too low, the knife is always close to your neck. On the other, if you artificially inflate your assumed costs and make them look unreasonable, investors will see through them and your reputation will receive an instant blow. Just make sure to be explicit with the investor about what you expect your real costs will be and what kind of buffer you would like to add on top.

Valuations

The valuation question is trickier to answer. Some quick ballpark numbers: seed and venture rounds tend to take between 15% and 35% in equity. Angels take a bit less but with higher variance; I would guess between 5% and 25%. The specific number, then, comes down to negotiation and various factors surrounding your company, such as its potential (market size/revenue potential in 3 to 5 to 10 years), the strength of the team, and current traction.

Under no circumstances should the founders give up the majority of their company anywhere between angel and Series A rounds. Investors asking for majority stake in the company at this stage are financial predators who are effectively trying to steal the company. It is the founders who are the key to the company's growth; how will they stay motivated and make key decisions if the investor has usurped control from them? Similar logic applies to angel investors who take more than a 35% stake in the firm: How can a venture fund make a follow-on seed investment into such a company without having to own a majority share together with the angels? Sadly, a lot of investors in our region don't realize that taking high equity stakes in the early phases of the startup lifecycle significantly hampers a company's ability to raise future funding, which in many cases leads to a premature and unnecessary end of the startup. I have seen multiple startups with a very promising product that Credo was not able to finance because investors owned way too much equity in the firm without adding any value to it.

The valuation of the startup also has to reflect its potential. If Sun Tzu were giving advice on fundraising negotiations, he would probably include something along the lines of, "Know what the VC's motivation is." And the motivation for most VCs is the same: make money. A lot of money. How much is a lot? We at Credo like to see at least 10x potential return for Series A investments, and more than that for seed investments (to compensate for the additional risk, as explained in the previous chapter). Therefore, make sure that your company's potential can justify your valuation. I am not sure if this is just a Central European phenomenon, but I see way too many business plans with a valuation that just doesn't make sense given the financial forecast the company is presenting. Example: A startup wants to raise EUR 2 MM in exchange for a 20% stake in the company but plans to make EUR 2 MM in revenue in 4 years. In order to deliver a 10x return for the fund in that timeframe, the company would have to be sold for EUR 100 MM. Do you really expect your company would exit for EUR 100 MM if it generates EUR 2 MM in revenue? Not going to happen, unless you believe in miracles or have Ev Williams in your top management.

Once you know the needed investment size and expected equity you would like to give to the investors, the valuation calculation becomes quite straightforward: Divide the investment size by the percentage of equity given out to investors. Example: If you are raising EUR 1 MM and you would like to give an investor a 25% stake in your company, your post-money valuation will be EUR 4 MM. Why is it called post-money? Because it includes money invested by the investors, i.e., valuation including the amount invested. The pre-money valuation is then calculated by subtracting the invested amount from the post-money valuation: in our example, the pre-money valuation would be EUR 4 MM (post-money valuation) less the EUR 1 MM investment = EUR 3 MM. Investors like to look at pre-money data to compare valuations of different startups before they are inflated by the invested amount.

When you advance in talks with investors you would like to fundraise from, try searching for valuations on their previous deals and benchmark your startup against their portfolio companies. AngelList and sometimes CrunchBase can provide useful data. You can bet the investors benchmark prospective investment opportunities against their portfolio.

Choosing the right partner

What is more important than the actual valuation, in my opinion, is to choose the right partner. Don't go with an investor who tries to compete on the best valuation. As a matter of fact, an investor who tries to convince you to go with him because of valuation is implicitly saying he can't offer much besides money. If you choose to go with such an investor only to have 5–10% more equity for yourself, you might end up owning 5–10% more of something that is worth a fraction (if anything) of the value you could have gained with a partner who can open the right doors for you. I hope the previous chapters gave you some guidance on choosing the right investor.

So much for the valuations and investment sizes. This chapter may appear more abstract in content. It is at least partially due to the fact that when it comes down to valuation, it is more an art than science—an art of negotiation.

During such a negotiation, it is always useful to know how the other side is evaluating you and what it is looking for. And that's exactly what the next chapter will try to uncover by looking deeper into Credo Ventures: What does a standard VC fund look like, and what does a VC think about when looking at an investment opportunity?

5. How Venture Capital Looks in Practice: The Credo Ventures Case Study

"I think I've read enough about the theory of fundraising and venture investing. But how do venture capitalists really work? How do they decide which investment to make?"

The Team: What Are Its Members' Roles Internally?

As you can read the basics on our website, the goal of this post is to provide more insight and context to that information. Let's start with the team. It consists of partners, associates, analysts, typically an intern (if you are interested in our 3-month internship program, get in touch), and a growing rank of venture partners and advisors. In some larger funds there is a position between partner and associate, typically called a principal, whose responsibilities overlap with those of a partner and an associate, which are described below.

Partners are the big guys who call the shots. They decide which opportunities Credo will invest in and then usually take board seats in the portfolio companies. Try to get to know the partner who will be leading the investment in your company as well as you can prior to investment. Make sure you have good chemistry with him, because you will spend a lot of time with that person, in good times and bad (and both will almost certainly come). Some people describe taking an investment as entering a marriage. Based on that analogy, the partner who sits at your board is your spouse. Get used to polygamy if your company makes it to Series A or beyond.

Associates support the partners wherever needed. And analysts support the associates. They might have different roles at different firms. I have borrowed this list from Mark Suster since it accurately describes the roles at Credo as well:

- Deal sourcing for partners
- Deal screening
- Deal support / analysis / quant / legal for deals a partner is seriously considering
- Portfolio company support & analysis
- Portfolio community building
- Industry reviews
- VC firm admin
- VC firm policy or fund analysis
- Helping be the VC “presence” at key events
- Alumni activities

The role of venture partners at Credo Ventures is to bring the specific know-how that could be needed for an investment. Venture partners tend to have industry and function-specific expertise that our portfolio can leverage. They are not full-time employees, but close colleagues with whom we are in touch frequently. Our venture partners come from various industries, such as software security, or focus on specific core competencies that are useful to our portfolio companies, such as business development or hiring.

Our advisory board fulfills a similar role, but from a higher perspective: A couple of times per year, we invite selected investment opportunities and all portfolio companies to meet with the board that is comprised of world class investors, such as Esther Dyson, Reshma Sohoni of Seedcamp, Stuart Chapman of DFJ Esprit, Jan Hammer of Index Ventures, and Andrew Banks of True Capital, who provide their feedback, mentorship, and industry contacts.

External Roles: How Does the Team Help Its Portfolio Companies?

"How will you add value to my company?" One of the most frequent questions I get, and a good one. The answer to this question should be one of the major decision factors when choosing your investor.

With that being said, the question is very hard to answer without sliding into clichéd or generic statements. That's because the most value the investor brings lies in the fact that he is simply there for the founders. The value of having the right partner by your side is often underestimated, especially by first-time founders. Being a CEO is a very lonely job. You always have to be enthusiastic and optimistic in front of your employees. You must appear to have all the answers and strategy figured out. The truth is that very often you just don't have the answers or may find yourself at the bottom of the emotional rollercoaster that the startup constantly rides on. If you have an experienced investor who has done this a few times before, you have a partner with whom you can discuss all questions and fears you might have at any time you desire. This is a big benefit that tends to get undervalued, unless you have walked down that path before. I recommend asking the partner who should be potentially leading the investment how engaged he plans to be with the firm.

And then there are the more obvious ways an investor should add value. Definitely try to cover all these topics with your suitors:

- Opening doors to customers. Having 30+ private investors who started the most successful firms in the region such as Avast, AVG Technologies, RSJ Algorithmic Trading and Linet allows Credo to open doors to a lot of customers. Add the network of our team, venture partners, advisory board, and 15+ portfolio companies (with many more to come), and you get a whole lot of doors.
- Sourcing employees. Startups are always in need of technical and sales talent. Cognitive Security needed to expand its senior sales team, so we sourced its VP of Sales and Sales Director for Western Europe.
- Finding complementary investors. No investor knows it all. If he tells you he does or behaves like it, he is lying—both to you and to himself. Credo has had a co-investment partner that brought valuable know-how to each of our 2013 investments, including Index Ventures, Flybridge Capital Partners, Baseline Ventures, Y Soft VC, Kima Ventures, XG Ventures, and Seedcamp.
- Providing follow-on capital. A startup almost always needs more money than it originally envisions. Recall that, according to CrunchBase, the average successful startup has raised more than 40 MM USD before making an exit. It is a great advantage if you have a fund that can support you from the seed phase all the way to Series B and beyond. With 60 MM EUR spread across our two funds,[i] we aim to be able to commit more than 6 MM EUR per startup.
- Providing operational support. Just read the list of associate's responsibilities.

How can you check whether the investor can in fact provide all the value he promises? Just ask his portfolio companies. Seriously. It is quite common to ask for references.

How Do We Look at Investment Opportunities?

Attempting to rationally explain a process that is inherently full of judgment calls and gut feelings is very difficult. Of course, we have a strategy on paper that we like to follow. And, of course, we make exceptions to that strategy. That's because, at the end of the day, the key criterion that influences our investment decision is a very

[i] Our second fund is still open to new investors.

subjective one: the team and its ability to execute. Nevertheless, here is an excerpt from Credo's investment strategy document:

	Description	Investment Size	Return Potential	Role of Credo
Seed	High-potential companies with a globally unique product	EUR 50-500k	> 20x	Typically lead investor (+ angel investors and/or LPs)
Spin-off	Tech-heavy and/or strong IPR-based. unique products on the target market	EUR 100-500k	> 10x	Typically lead investor (+ angel investors and/or LPs)
Series A	Companies with convincing product/ market fit (existing customers) and initial revenues of at least EUR 100k annual run rate or otherwise proven traction	up to EUR 2.5M	> 10x	Typically lead investor, but willing to co-invest
Series B / Early Growth	Established firms with revenues in excess of ~ EUR 1M in annual run rate	up to EUR 6MM	> 5x	Predominantly co-investor alongside local and/or blue chip VCs

I recommend looking at that table in the context of the startup investment cycle explained in the previous chapters. The thing to remember is that any strategy put on paper is just an indication. If an investor likes the entrepreneur and his vision, he will either invest himself or help find the appropriate investor. And if he doesn't do so, then at least you can cross such an investor off your list of potential sources of funding, because he either doesn't like you or is not a good investor.

Now that we have looked at how the investment cycle and its investors actually work, let's dig deeper into the fundraising process itself.

Section III. Fundraising

6. Five Mistakes to Avoid When Approaching an Investor

"All these investors claim that there are not enough opportunities out there to invest in, yet when I send them my business plan, I don't even get a response."

Considering that venture capital investors get tens of thousands of business plans, investor decks and other pitches annually, it is hardly surprising that not all of them get an investment. Based on many conversations over the years, it seems that a lot of entrepreneurs don't even receive a response to their presentation. At the end of the day, this is the investor's fault. But there are certain mistakes that I have seen entrepreneurs approaching Credo commit over and over again, which significantly diminish the chance of any investor reacting to their pitch. And they are pretty easy to fix. Here are the top five, which anyone can and should avoid:

Your Startup Doesn't Fit the Investor's Criteria

If Credo's website says we invest in IT, internet, mobile, and health startups in the CEE region, we are not going to invest in a gold mine in Mongolia. If the site says we invest in seed, Series A, and Series B stages, we are not going to make an angel investment.

It is not that hard to research the fund's site and portfolio to find out what kind of investments it is looking for. Some people say that if the fund has already invested in a startup in the same space as you, you shouldn't bother asking for a meeting. While I agree that the chances of receiving an investment from a fund that has already invested in your space are pretty slim, definitely try to get a meeting, because you can gain access to a ton of market intelligence. It is more efficient to learn from the mistakes of others than from your own.

You Cold Call Potential Investors

This may sound more difficult than it really is: Don't send your pitch unannounced, especially to generic email addresses such as info@abc.com. And no, mailing in a hard copy of the business plan doesn't help, either.

Try to get introduced to any member of the investment team before sending the pitch—the more senior, the better. Leverage your network; do your LinkedIn/Angel List research. If you come out empty-handed, attend a conference where these investors speak or participate; on average, one of our team members is at one conference per month at least. Follow the investors you are interested in on Twitter; I announce all the conferences I am attending on my account. One of the reasons why I attend these events is to meet new startups, so I would not say no to hearing a pitch if you approach me.

If for some reason you are not able to meet the investor, at least try asking someone affiliated with the fund to make the introduction: investors of the fund, CEOs of portfolio companies, etc.

Your Introductory Email Doesn't Contain Relevant Information

I am still very surprised at how many startups don't fundraise with a proper deck or are not able to write a clear executive summary in the body of their introductory email. Getting the investor deck right is an art, but anyone who follows the criteria outlined in this presentation[4] from our friends at One Match Ventures (link at the end of the book) passes the minimum acceptable quality bar for Credo. Even angel investor decks have their guidelines[5] (again, link at the end of the book).

The accompanying email is equally important—make it short and make sure it includes at least:

- Where I know you from
- What your company does[6]
- What you are asking for
- Anything to spark my interest: traction, committed investors, even something out of the box ("Andrej, I am a regular contributor to your favorite charity")

You Have Hired an Advisor

This is a big no for any startup below at least Series B level. If you, your team & existing investors are not able to raise an investment without an advisor, you can be pretty sure that the advisor is not going to help (unless you are willing to try the exotic route, such as a Dubai-based investment fund). Advisors can be very useful at an exit, but not for taking an early stage investment.

The advisor might brag that he has a lot of connections. This might be true, but investors in general hate receiving pitches from advisors, so the quality of such introductions is very low. I recommend sticking to strategies laid out in the second point when it comes to connecting with investors.

The advisor might claim that he can prepare a better presentation and financial model than you can. This is definitely not true—stick to the guidelines from the third point when it comes to the investor deck. And when it comes to the financial model—you don't need an overcomplicated Excel monster; as a matter of fact, most investors don't have the time to study it anyway. Stick to something simple and logical; I devote an entire chapter to it later on. And if the investor likes you and your company, he will help you prepare a more in-depth model, which you can then use as a budget.

Investors don't like advisors much because, in their minds, advisors don't add value to the startup yet get paid for it. Maybe some investors like using advisors; I would be curious to learn why. I don't think Credo has ever made an investment in a startup with an advisor.

Your Startup Doesn't Make Sense

At the end of the day, all of these tips will be worthless if your startup doesn't make sense. Does it solve a real problem? Does it solve it 10x better than today's solutions? Do you have the right team to pull it off?

If you don't have answers to all these questions (and a bunch more), even the best connections and the most beautiful investor deck are not going to help you.

7. Fundraising: From the First Meeting with a VC to a Term Sheet

"I managed to land a meeting with a VC; what should I expect? How do I get a term sheet out of him?"

If you have approached your investor successfully and have booked a date for your first meeting, it is crucial to prepare as well as you can. The goal of this chapter is to shed more light on a typical fundraising process with a standard VC firm and offer some guidance on how to survive it all the way to obtaining a term sheet.

Before the First Meeting

It is very important to know well the person (people) you are going to meet with beforehand. Ideally, there will be a partner at the meeting in addition to an associate or analyst. As explained above, only a partner can become the "champion" of the investment, i.e. the person who will recommend investing in your startup to the rest of the partners / investment committee and will eventually join your board of directors. If you "only" get a meeting with an associate or analyst, the associate will first have to convince a partner that it is worth meeting with you.

Once you know who will be present at the meeting, find out what companies these people have invested in (the partner who gets quoted in a press release regarding an investment is the "champion" of that deal) and what their sectors of expertise are. Try to find as many synergies as you can between your startup and the partner's investments. Before these meetings, we typically discuss which partner is the best fit for each startup.

During the First Meeting

The basics are important: Show up on time, ask how much time you have for the meeting, and be sure to finish your presentation in half of that time (reserve the second half for questions). You can use Guy Kawasaki's 10/20/30 rule for guidance: 10 slides, 20 minutes, 30-point font.[7] I think in reality you can have 12–15 slides with additional ones in an appendix as a backup for follow-on questions.

It is very important to establish a conversation with a VC: A dialogue is much more exciting and memorable for an investor than a lengthy presentation.

Start with your team's bio, background, and the path that led you to your idea. It helps build a memorable story. The team and its ability to tackle the problem the startup is solving are the most important factors in an investment decision. Make sure that your core team has all the know-how necessary to execute the idea (e.g., if you are a "business person"/consultant who hired an external firm to develop the product, I can guarantee you that I am not going to invest) and be sure to highlight this throughout the whole meeting.

You can find plenty of resources on what else to cover in the first meeting online. I had an hour-long presentation on the topic at WebExpo.[8] The pitch template[9] from One Match Ventures for guidance is a great resource as well.

After the First Meeting

The two possible conclusions of the first meeting are fairly obvious: The partner either liked you and your startup, or he didn't. However, it might be less obvious to figure out what the conclusion of the meeting actually is. Unless your meeting went really badly, the investor rarely says a flat out "no." Instead, he might say something like, "Sounds interesting, it might be a bit too early for us, but let us know once you have more traction," which basically means, "No. But just in case you do manage to get substantial revenue against all odds, please come back and see us since I didn't tell you 'no.'"

If the partner did like your startup, he will try to verify his opinion and tackle the main risk considerations with industry experts and internal analyses. If you have made any follow-up commitments, such as sending additional data, make sure to complete the tasks as soon as you can, i.e. within 24 hours of the meeting, along with a thank you note for the meeting.

Sometimes there are follow-on meetings with these experts or with the team, and they will confront you with the outcome of the analysis. This process can take a couple of weeks to a couple of months.

Once you handle all the follow-on questions and outstanding issues, you will be invited to a partners' meeting or an investment committee meeting, both of which serve the same purpose—putting a final stamp of approval or disapproval on the investment. The structure is very similar to a first meeting: A startup typically goes through the whole investor deck, but there is less dialogue due to number of people involved—our meetings consist of six to eight individuals, not including the entrepreneurs.

The Terms

So when exactly does a VC open the valuation / terms discussion? This is quite individual. Some partners prefer to ask for a valuation at the end of the first meeting, but I have very rarely seen a negotiation on terms at this stage. It is more typical to see a VC react to the valuation only once he has covered the startup with fellow partners and industry experts. Typically, there is an agreement at least on valuation, if not the entire term sheet, before the startup presents at the partners' meeting.

Sometimes a startup gets overconfident about the investment process and thinks that the investment is sealed before the partners' meeting. Don't forget that even if you already signed a term sheet (which is rarely the case before the partners' meeting, even if you have agreed on most terms in it), it is a non-binding document.

The most important factor influencing the successful outcome of the investment process is the strength of the relationship you form with the "champion" partner of the VC fund and his conviction for your startup. Remember, you will spend a lot of time with this person, so make sure you do become friends in the process. And if you don't feel the chemistry, don't be afraid to pass on that investor—you will save yourself a lot of trouble down the road.

8. Term Sheet Guide, Pt. 1: Introduction to Term Sheets

Once you have caught the investor's attention and have managed to get through the investment process, the time has come to negotiate a term sheet. Such negotiation can be very tricky and complicated, especially for first-time founders. The next three chapters will try to lay a foundation for a basic term sheet guide that should help founders, especially of seed-stage companies in Central Europe, navigate their term sheets.

What a Term Sheet Is

Before we dive into individual terms, it is important to understand what a term sheet is: a non-binding summary of key terms of the proposed transaction. There are typically just two binding provisions: confidentiality and exclusivity.

Confidentiality limits the amount of information an entrepreneur can share with anyone besides the investors who have proposed the term sheet. Basically, once you sign a term sheet, you should not discuss the terms with anyone who has not signed it. While this clause only becomes valid after the term sheet has been signed (just like exclusivity), it is important to treat the information sensitively even before a term sheet is signed. You will not make your potential investor too happy if you forward his term sheet to other investors to solicit a better offer.

Exclusivity prevents the entrepreneur from negotiating with other investors for some finite period of time. At Credo, this period ranges from 45 to 90 days after the term sheet is signed (the amount of time we expect it will take to close the transaction). The goal of the exclusivity provision, similarly to confidentiality, is to ensure that the entrepreneur doesn't use the signed term sheet as a negotiation tool to attract more investors / better terms. If the transaction does not occur within the specified time frame, the entrepreneur can resume negotiations with other investors.

Why Focusing Too Much on Valuation Can Damage Your Startup

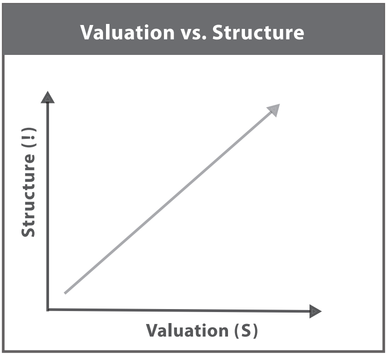
Let's start the discussion with the provision that many entrepreneurs consider the most important: valuation. If you are interested in specific valuations and investment sizes, check out one of the previous chapters. This post is about structure, not numbers.

I agree that valuation is very important. At the same time, I would argue that many entrepreneurs (especially first-timers) overemphasize its importance, which entails quite a few risks.

First, you might not get a deal done with the fund you prefer. Sticking with a fund that provides the best valuation can have short-term gains but can cost you in the long run. As explained previously, a fund that competes only on valuation is indirectly saying that such a fund can't add much value. Choosing the right partner whom you trust can really boost your startup; even if it means a cut to today's valuation, it can result in a much more valuable startup later on. I have seen too many startups get killed because they chose the wrong investor.

Second, a high seed valuation sets a high hurdle for subsequent rounds as well. Say you want to raise your seed round at EUR 3 MM valuation, and you expect that valuation to triple or quadruple by Series A to make it an attractive proposition for your investors. Do you know how many companies raised a Series A at EUR 10 MM valuations or higher in Central Europe? A handful. Would you not prefer to raise your Series A at EUR 5 MM if you were much more likely to raise such a round? The numbers I've used are just for illustration, even though I do strongly believe that you are much more likely to raise cash in subsequent rounds (i.e. once you achieve your product / market fit) if you don't push too hard on valuation in the earlier stages.

The third and most important point I want to mention is the structure: The more you focus on valuation, the more incentivized the investor is to include other harsher terms in the term sheet in order to protect his downside. I have borrowed a very simple diagram from Jamie McGurk to illustrate the point:



These terms and the resulting complicated structure can often be much more detrimental to your startup than a lower valuation would be. As a first-time founder, you will have a very hard time going through a complex term sheet and identifying what impact these terms can have on your startup. And that's precisely the point of my small term sheet guide: to explain to founders each of those terms and the implications they may have for their startup.

9. Term Sheet Guide, Pt. 2: Convertible Loan

Before we dig into individual terms, it is important to distinguish between the two most common methods of investing: convertible loans and equity investments. In an equity investment, an investor receives a stake in the company in exchange for cash. Plain and simple. If the investor provides a convertible loan instead, he will provide a loan with a maturity date, interest, and a special twist: the right to convert the loan into an equity stake in the company at some point in the future.

The goal of this post is to cover the convertible loan—in general, the less commonly used investment method. It typically contains just a few terms that can easily be covered in a single chapter.

Definition of a Convertible Loan

As mentioned above, a convertible loan is short-term debt that converts into equity. Usually it converts at the next investment round. Example: If you receive your seed investment in the form of a convertible loan, it will convert to equity when you raise your Series A investment.

The advantage from the perspective of an entrepreneur is that a convertible loan, before its conversion, behaves very much like a standard loan: The investor typically does not have many of the rights of a preferential shareholder (board seats, liquidation preferences, etc.). Since it is a fairly short and simple document, it also gets executed faster (that's why convertible loan investments can be processed faster than an equity investment, typically by a couple of weeks). Additionally, a standard convertible loan does not require an immediate payment of interest. Instead, it gets accrued and converted to equity, as explained below.

The disadvantage also comes from the very nature of the loan: Until the loan gets converted to equity, the investor has a priority right at the maturity date to claim any assets (i.e. cash and hardware for most startups) in order to get the loan and interest repaid. Needless to say, most startups don't have enough cash to repay the loan at maturity and thus are forced to liquidate all assets and close down the business if the loan doesn't convert.

Why and When to Use a Convertible Loan

There are a couple of scenarios when a convertible loan can be used. First, it may serve as a source of "bridge financing" before an anticipated large financing round. Say you raised a EUR 200,000 seed round and are now in the process of raising EUR 2 MM Series A, but you still need a few more months to complete the round. So you take a EUR 100,000 convertible loan as an extra cushion for the fundraising process. As mentioned above, convertible loans are faster to execute from a legal perspective, so the whole transaction can get processed in a matter of few weeks. Bridge financing can be tricky, though: If investors are not 100% convinced that things are going well, asking for a quick convertible loan may give rise to major concerns regarding performance and outlook (i.e. the question "Why would you need more cash in order to fundraise?"). Losing existing investors' confidence is a very bad way to start the fundraising process.

Second, the convertible loan is used at times when investors and entrepreneurs can't agree on valuation, especially when they define a conversion discount but not necessarily the valuation cap (explained below). I am not a big fan of this use case: Instead of facing a major issue straightaway, both parties decide to shift its resolution to some later point in time. Such a strategy can very easily backfire, creating nasty arguments between investors and entrepreneurs, which can block further fundraising and thus kill a startup.

Convertible loans are also increasingly being used at the seed stage. There is plenty of criticism against this practice from VCs, especially if the notes are overused and include harsh terms. I recommend reading a piece by Mark Suster[10] on the topic.

Terms You Can Find in a Convertible Loan

Maturity date: This is the time by which the loan matures. First thing to understand: The investor can require the repayment of the loan at the maturity date. This is used to protect his downside: If the startup is not doing well, the investor can still recoup his investment and interest at the loan's maturity date (and kill the startup if it doesn't have enough money to repay the loan).

Interest rate: This is the interest the startup shall pay on the loan. It is typically a PIK (payment in kind) interest; i.e. the startup doesn't actually pay the cash. Instead, the interest gets accrued to the principal of the loan. In such a case, the accumulated interest gets converted into equity together with the principal of the loan. Example: If you raise a EUR 100,000 convertible loan with 8% interest that gets converted into equity in 12 months, the actual amount that gets converted is EUR 108,000. The most common rates we have seen hover around 6–8%.

Conversion: This is a very important clause that describes the conditions under which the loan is converted to equity. The most typical mandatory conversion scenario is upon "qualifying financing": Once a startup raises more than EUR XX (i.e. raises a "qualifying financing" round), the loan gets automatically converted into equity. The most investor-friendly alternative for conversion is at any time the investor chooses, but this scenario is very rare if the startup has raised additional capital. Typically, if the startup doesn't raise any new capital before the maturity date, the investor has a right to decide whether he wants to convert or not.

Qualifying financing: The minimum amount a startup has to raise in the next financing round in order for the convertible loan to be automatically converted to equity. The amount varies widely depending on whether the startup is raising seed, Series A or further later-stage capital.

Conversion discount: The investor typically converts his loan to equity with a conversion discount in valuation compared to new investors to compensate him for the additional risk of having entered the startup earlier than the new investors. Example: Say new investors are entering the startup at a EUR 5,000,000 valuation. If the note has a 20% valuation discount, the holder of such a loan can convert the entire amount of the loan (and the interest, as explained above) to equity at 5,000,000 * 80% = EUR 4,000,000. A standard discount we typically see on a convertible loan is 10–30%, with 20% being the most common.

Valuation cap: In addition to a conversion discount, an investor can also set a valuation cap, i.e. the maximum valuation at which the loan will convert. Let's use the example above, but say that the terms also included a valuation cap of EUR 3,500,000. Without the cap, the investor would convert at EUR 4,000,000 valuation, but with the cap, the investor can convert at EUR 3,500,000.

These are the most common terms an entrepreneur can find in a convertible loan, at least based on what we at Credo Ventures have experienced.

Nevertheless, we tend to prefer equity rounds: Rather than hiding / avoiding terms or valuations, we agree on the whole structure at the beginning so we can focus on what is important: creating value for the startup.

10. Term Sheet Guide, Pt. 3: Equity Investment

Our term sheets try to mimic what we consider a standard set of rights used by U.S. venture capitalists. By using a “Western” structure since the very early days in its lifecycle, a startup can, in our opinion, improve its likelihood of raising future rounds from Western investors.

The Terms

Investment tranches: Right after the investment size and valuation (topics I’ve already covered), you will typically find the investment tranches. In order to protect his downside, the investor can split the investment into multiple tranches and include conditions / milestones (customers, revenue, product, etc.) under which each of the tranches will be released. In the seed and Series A levels, we tend not to tranche the investment too much, since it is very hard to set meaningful milestones in such early stages. In seed, we tend to give the whole amount at once or sometimes have it divided into two tranches. Series A is very similar; if it is a larger investment, we might include an extra tranche.

Stock options plan (SOP): I will devote two chapters to employee equity later in the book. In short, we typically want to devote between 10–15% of company equity in the stock options plan at the seed level. The timing of the creation of the SOP is important: If the term sheet says the plan should be created before the transaction is closed, the equity will come from the stake of original shareholders. If the SOP will be created after the transaction, the investor will get diluted as well.

Board of directors: This one is tricky and pretty important, because some investors (especially the non-standard ones or occasional business “angels”) may use the board to usurp control of the startup.

Since we try to add value by being hands-on in our companies, we typically nominate one director to the board by Series A at the latest. We have some seed investments with no board of directors or with a board consisting only of management. We have never taken majority in a board at seed or Series A level; the management should, in our opinion, always keep the majority of the votes (by having more directors than the investors have) at this stage. Our boards of directors typically meet monthly. Beware of investors that want to take majority or an equal number of seats as management in the board by Series A.

Important caveat for Central European entities: The board of directors is not always a statutory body of the firm supported by the legislative framework in a given jurisdiction; the board can be a newly created body backed up by the transaction documentation of the investment. The board has a list of items that it must approve (e.g., expenses greater than XX EUR, hiring of key people, sale of shares in the company, etc.), some unanimously, some by majority of the vote. This item list is also part of the term sheet.

<u>Lock-up rights</u>: They limit founders' ability to sell their shares without the consent of the investor. The investor invests in the people—why would he want to be part of a company in which the founders can sell their shares and leave at any moment?

<u>Tag-along / co-sale right</u>: Based on similar logic as the lock-up rights, the tag-along clause describes the right of an investor to tag along in the sale of the firm if the founders choose to sell a larger portion of their shares. Example: If the founders decide to sell 10% of their stake to a third party, the investor will have a right to sell his entire stake under the same terms as the founders. If the buyer does not want to buy the investor's stake, he can't buy the founders' stake, either.

<u>Right of first refusal</u>: This is another right in the same class as the lock-up and tag-along rights. Right of first refusal states that before any shareholder sells his stake to a third party, he must offer his stake to existing shareholders at the same terms. The selling shareholder can only sell the stake if remaining shareholders don't want to buy it.

<u>Pre-emption / pro rata rights</u>: This clause essentially reserves the right of the investor to participate in the future financing rounds. Typically this includes a pro-rata right: Let's say that an investor owns a 20% stake in a startup which is about to receive

additional EUR 5,000,000 investment. A pro-rata right allows the investor to invest EUR 5,000,000 * 20% = EUR 1,000,000 at the same terms as the rest of the investors. In our seed investments, we sometimes include more than a pro-rata right to make sure that we can deploy more capital into really promising companies.

Anti-dilution: This one can also get very tricky, and some investors use it to limit their downside risk. The anti-dilution clause describes how each shareholder gets diluted in a "down round": a future investment round with a lower valuation than the current investment round. There are two basic concepts: full ratchet and weighted average anti-dilution. While full ratchet essentially means that only the founders will get diluted (i.e. investors don't get diluted at all), weighted average approach assumes dilutions of both investors and founders. If you want a deep dive into the technicalities of the anti-dilution clauses, check out a post by Brad Feld.[11]

To my knowledge, Credo has never used full ratchet, since we consider it very entrepreneur-unfriendly.

Liquidation preference: This is a very important clause that is sometimes overlooked by entrepreneurs. It is one of the key terms used to protect an investor's downside. Generally you will find one of the two variations of the liquidation preference definition in a term sheet: participating or non-participating, or their combination (i.e. capped participating, even though that's quite rare in my experience).

The easiest way to explain liquidation preference is using an example. Let's say an investor invested EUR 1,000,000 for a 10% stake in the company. If this investor has a non-participating liquidation preference, he has a right to choose at a liquidation event (i.e. exit or any kind of transaction that involves a buy-out of existing shareholders, not just a bankruptcy sale, which is the most common understanding of liquidation) whether he would like to receive the preferred return specified in the liquidation preference clause or 10% of the exit price. Most typically, the preferred return is equal to the amount invested (in our example, EUR 1,000,000), but can be a multiple of that amount (e.g., 2x liquidation preference corresponds in our example to EUR 2,000,000). Let's say the investor in our example has 1x (also called “simple”) liquidation preference, i.e. EUR 1,000,000. When the company gets sold, he can choose whether he would like to receive EUR 1,000,000 or 10% of the exit price. Using simple math, it makes sense to choose EUR 1,000,000 if the exit price is below EUR 10 MM and to choose 10% of the company if the exit price is above EUR 10 MM. Likewise, if the investor has 2x liquidation preference (and thus his preferred return is EUR 2,000,000), the exit price at which it becomes interesting to take the 10% of the company instead of the preferred return is EUR 20 MM.

Things get a bit more complicated with participating liquidation preference. In this scenario, the investor at exit first gets his preferred return, and then the rest of the exit proceeds get distributed pro rata among all shareholders. Let’s take the example above: The investor has provided EUR 1 MM for 10% of the company with 1x participating liquidation preference. If the company gets sold for EUR 10,000,000, the investor first gets EUR 1 MM, and then also 10% of the remaining EUR 9 MM for a total of EUR 1.9 MM.

In general, we tend to stick with a simple 1x non-participating liquidation preference, which is the most entrepreneur-friendly alternative. Entrepreneur-friendly liquidation preference is also important for attracting future investors or exit partners who don’t want to see a disproportionate amount of the acquisition price going to investors as opposed to entrepreneurs. Nonetheless, if the entrepreneur has unreasonable valuation expectations, we tend to include stricter liquidation preference (2–3x non-participating). At Credo we have decided (after a heated debate) not to use participating liquidation preference in the future, since we consider it too entrepreneur-unfriendly. Simply put, if we can’t reach an agreement on an acceptable valuation, we would prefer to walk away from a deal rather than include harsh terms that can cause fights between founders and investors and deter future investors from investing.

<u>Drag-along right</u>: This right allows an investor (or, in case a startup has multiple investors, after agreement among all existing investors) to drag all remaining shareholders (including the founders) to sell their shares if the investor decides

to sell his. Typically, this right can only be exercised after a certain time period; standard is 1–3 years after the transaction. Sometimes, the execution of a drag along right has to be approved by startup's board of directors.

A lot of entrepreneurs worry about this right and it is easy to see why: At first glance, it seems that the investor can decide the fate of the company without consulting the founders. What the founders must realize is that no buyer will buy a company if the founders don't want to sell, because the founders and their team are an essential part of what the acquirer is buying. That's why a drag along can only work in practice if it is also endorsed by the founders. We at Credo have never exercised a drag-along right before, but we still want to have it in the term sheet. It is for the unlikely event that some shareholder (typically a non-essential one, such as a fired, angry, early employee who has a stake in the company and wants to damage it) tries to block a transaction.

<u>Founder's vesting</u>: Another right that deals with founder quarrels. Essentially, when founders take an outside investment, they will not own their entire equity outright. Instead, it will vest over time. If you are not sure what vesting is, please read Fred Wilson's post.[12]

Let's describe the mechanics in an example. Our typical terms are the following: At signing, each founder directly owns 30% of his stake. The remaining 70% of the stake gets vested over the next 4 years. How does this look in practice? Let's say a founder is supposed to own 50% of the company once the investment is made. According to founder's vesting, he will own 50% * 30% = 15% of the company outright. In 2 years, he will own 50%*30% + 50%*(1-30%)*(24/48 months) = 32.5%. In 4 years, he will own the full 50%.

At first glance, this may seem like a very entrepreneur-unfriendly clause. Nonetheless, we use it especially in our seed investments where the founders are working on their first venture together. It has a simple reason: Let's say there are four founders, and each owns a 25% stake in the firm. There are plenty of real life cases where one of the founders gets into an argument with the others and leaves. If there is no founder's vesting, all of a sudden you have a 25% shareholder in your company who not only doesn't add value to the firm, but may be angry and on a mission to sabotage the rest of the firm just to get back at the others. Founder's vesting thus helps mitigate the consequences of founders' quarrels.

Reporting: Be prepared that an investor will typically want to see a monthly report, or at least a quarterly one, in the very early stages of startup's lifecycle. In general, this includes a monthly income statement and balance sheet (which your accounting firm can produce) along with a short qualitative commentary from the CEO on important news of the month. These materials also serve as supporting documents for a board meeting.

No Lawyers

I strongly recommend resisting the urge to invite a lawyer to review the term sheet, especially if it is not a Silicon Valley lawyer who has executed hundreds of similar transactions. Most of the local lawyers don't understand startup investing but want to have as much input as possible so they can clock in (and bill) more hours. Things can get very counterproductive very quickly; unfortunately, we have had to walk away from a couple of transactions where the startup invited their friend-lawyer to review the term sheet, which resulted in a total mess.

If you want advice on a term sheet, read blogs of other VCs like mine, or get help from respected startup mentors, whom any accelerator or angel can recommend. Just please avoid inexperienced lawyers who are more interested in billing their hours than helping the startup succeed.

Random Remarks

These terms might initially seem quite controversial. That's why it is very important to sit down with the VC who offered the term sheet and let him walk you through the logic of each term. If something sounds fishy to you, it is very easy to Google each of the terms. Plus, if you really want to take a deep dive on term sheets, you can always order some literature on it. I can recommend a great piece by Alex Wilmerding.[13]

I used this analogy before: Some people say that accepting an investment from an outside investor is like getting married. If that is so, the signing of a term sheet is like getting engaged. How often do you see couples starting a happy relationship by having a long argument? Just keep that in mind when you are negotiating the term sheet. The way you start the relationship with your investor might be very indicative of where it might be heading.

11. Why Not to Fundraise in the United States

"European startups are able to raise just a fraction of the capital at home compared to their U.S. counterparts. And U.S. startups receive a lot more value from their investors. Why would I ever fundraise anywhere outside of Silicon Valley?"

I have received quite a few such comments on my blogs in the past. And, to be honest, I am not very surprised. Looking at the numbers, the decision to fundraise in Silicon Valley for European startups seems pretty logical—at first glance. But I am going to argue the opposite: For most European startups at seed and Series A stage, fundraising in the U.S. doesn't make sense. Or worse, it can even kill the startup.

The Art of Self-Promotion

A couple of stats from the U.S.: Clinkle raised USD 25MM seed round on an app that hasn't launched yet. GitHub raised USD 100 MM Series A round from Andreessen Horowitz. Let's compare these numbers with seed and Series A rounds in Europe: Trustev raises USD 3 MM in one of Europe's largest seed rounds. Meanwhile, GitHub's investment is bigger than entire funds in Europe focusing on Series A (including ours). Looking at such data, no wonder European startups want to fundraise in Silicon Valley.

One of the things that Silicon Valley is very good at is self-promotion. Every day, Europeans open U.S. tech blogs that glorify the next USD 10+ MM Series A, making it look like it is everyday business in the Valley.

I love Nikhil Basu's 2014 analysis of Series A in the U.S.[14] because it shows just how far off from reality such an image is. The average size of Series A investments hovers around USD 6 MM, while the median is at USD 3 MM. That's actually pretty close to the estimated size of rounds of even our "poor" Central European region that I mention in my analysis above. And one more stat from Tom Tunguz[15]: Just 20% of seed stage startups are able to raise a Series A in the U.S. Rude awakening.

The message that these numbers send to European entrepreneurs hoping to raise USD 8+ MM seed and Series A rounds if they move to Silicon Valley is clear: You are living in a dream.

The Reasons for Higher Investment Size

Some might argue that even a 1–2 MM difference is big enough to justify a U.S. fundraising trip. Yes, it is most likely true that the average and median investment size in the U.S. is somewhat higher. But there is an objective reason for why U.S. startups raise more than a European startup would: higher costs.

Scott Purcell of Jobspring Partners (a recruitment agency focusing on technical employees with a strong presence in Silicon Valley) mentioned that in 2013 the base salary of a senior engineer for a Series A+ startup was USD 165,000.[16] I must smile when I compare such figures to discussions I have with our Central European startups, some of which consider a USD 4k monthly salary for a senior developer very high.

It is such a shame that many European startups still wish to relocate to the U.S. and thus give up one huge competitive advantage that we have over Silicon Valley: lower salaries of technical employees that allow us to build a world class product for just a fraction of what it costs in the Valley.

If I compare the average investment sizes (3–6MM in the U.S. vs. 1–3MM in Central Europe for Series A) with the average costs of a technical employee (USD 160k in the U.S. vs. USD 30–50k in the Czech Republic), I could argue that Central European investors are actually more generous than their U.S. counterparts. That's because the average investment size might be twice as high in the U.S. (median is even less than that), but the average cost of a technical employee (which tends to comprise the majority of the burn rate of an early stage startup) is 3–5x higher.

Don't Take Seed / Series A from a Blue Chip U.S. Fund

I meet quite a few entrepreneurs who decide to fundraise in Silicon Valley despite being fully aware that the math is overwhelmingly against them. Why? They say it is because the Sand Hill Road titans, the famous venture capitalists of Silicon Valley, have experience and connections that cannot be matched by any European investor.

I can agree with that to a certain extent. But having seen the experience of such entrepreneurs coming back from their U.S. fundraising trips, I cannot help but say that I don't think it makes sense for most European startups to raise seed money, and in most cases even Series A, from blue chip U.S. funds. I have three reasons to say that:

First of all, the fundraising process is longer and more expensive than founders expect, and in most cases the process doesn't lead to an investment. Many European founders think that they will arrive in Silicon Valley and in a month or two come back with a check from Sequoia or Andreessen Horowitz. Encouraged by positive feedback after a 10-minute conversation with a junior person from a good fund during a networking event (a nice thing about the Anglo-Saxon culture is that they appear always to be positive), the entrepreneurs think the check is right around the corner. 3–6 months later, they still don't have a closed deal because the fund is asking for even more proof of concept defined as more traction, ideally in the U.S. (a polite way of saying that the fund is not ready to invest). How can a startup in seed / Series A stage survive without its CEO / co-founder who is halfway across the globe for 3–6 months? If such a fundraising process doesn't kill the startup entirely, it surely causes a massive defocus from what is really important: building an ass-kicking product and company.

Second, the blue chip funds very frequently require the team (or at least its part) to relocate to the U.S. They don't have the time to travel to Europe for board or team meetings. This often puts a lot of strain on the team, since it might have to split into two (part of the team staying in Europe and part moving). Further, the logistics of the relocation (Visa, office, admin, etc.) take months to resolve, causing even further distractions.

The third reason is the saddest. Let's say you somehow defeated the odds, managed to fundraise from a great Sand Hill Road investor, survived the relocation of your team, and are now ready for that famed investor to introduce you to a bunch of customers, give you regular feedback on your product, and provide guidance on how to build a firm. And then, nothing happens. You call your VC and he tells you how busy he is and that he might be able to meet you in a week or two, if he actually picks up the phone. And then the math creeps up again: The fund manages USD 1+ Bln. and has 100+ portfolio companies. The 10+ partners that manage the fund must split their time between all these companies and see a couple of potential investments per day. How much time do you think they can allocate for a company they invested USD 3 MM, or 0.3% of their fund, into? Especially if it is in the portfolio section next to GitHub or Clinkle?

When to Go to Silicon Valley

Don't get me wrong; there are European companies who raise from U.S. investors at the seed and Series A level and are very happy. A case in point is our portfolio company Apiary. But a lot of things have to go right.

I am a huge fan of Silicon Valley investors and am convinced that they can add a tremendous amount of value to any European company. I think the key factor in getting the U.S. fundraising right is timing. I love to see our startups tweaking the product and proving the business model in Europe first, and thus maturing into U.S. expansion. They use part of the Series A investment to set up the U.S. office, sign first customers there, and gently start flirting with U.S. investors. And when the time is right, they raise the Series B and C from the Sand Hill Road investors who help them conquer the world.

By then, the investment is big enough for U.S. investors to be motivated to help the startup (even to travel to board meetings in Europe!), and for the European seed and Series A investors to be happy about their returns. And for the entrepreneur to be excited that he has conquered the Western world the mature way, one step at a time.

12. How to Build a Financial Forecast That Will Look Attractive to Investors

“Why should I build a financial forecast for my fundraising presentation? There is no way I can predict what kind of numbers I can hit in the next four years.”

This is one of the most common reactions we at Credo Ventures get during a pitch when we ask about a financial forecast. And let’s not forget about, “I built a conservative model showing USD 1 MM in revenues in four years so I won’t look foolish,” and, “I wanted to show USD 500 MM in revenue in four years because I heard investors like big numbers, right?” These three reactions summarize the ways many entrepreneurs approach building a financial forecast.

The investors you are talking to (especially those with a financial background) will poke holes in any model you build, so get used to it. The goal of this chapter is not to share a manual that, if followed, will produce tears of joy in every investor’s eye. I would gladly share such a piece if I believed it exists. A lot of the mistakes I have seen entrepreneurs commit over the years have to do with the attitude and approach toward building the forecast, not necessarily with the lack of Excel skills.

If you have the right approach toward forecasting, it shouldn’t be too difficult to build a model that won’t embarrass you during an investor meeting. I will first try to explain the problems with the approaches mentioned above, then give some inspiration from later-stage companies, and conclude with thoughts on how to replicate the later-stage approach at Series A level.

When to Build a Forecast

Before tackling the "how" question, it is more important to understand when you are expected to have a financial model. I have argued in one of the previous chapters that it is ridiculous that some angel investors, especially in Europe, require lengthy financial models. In my opinion, companies raising their angel and seed rounds shouldn't bother with complicated models (after this post, I hope it will be obvious why); instead, they should be able to clearly show (i) how much they want to fundraise and why, and (ii) that they are attacking a large, ideally multi-billion dollar market.

The trickiest part is to build a model for Series A fundraising, when you are expected to show a serious forecast including revenue projections rooted in your knowledge of the market, yet (in most cases) you have no first-hand experience with customer acquisition at the scale of the specific product the startup is building (since most seed companies are pre-revenue or generate little revenue from early adopters and friends).

What to Avoid

Here is the problem with the first approach to forecasting mentioned above: not building one. Investors understand that you can't build an accurate model for the next four years. For them, the model is a tool that shows how you think about your market, how well you know it, and what your assumptions are. At the same time, they are testing your attitude and personality. The most frequent reason I hear for not building a model is that it is either too difficult or it just doesn't make sense. But this answer makes me wonder what would happen if your startup ran into challenges that you consider too difficult, or your market desired a product you don't believe makes sense and isn't worth testing.

If your model shows USD 1 MM in revenue in four years, how will you justify 10x+ return for your investor's USD 500k investment? The same logic applies to any Series A investment proposal in which the investment size is a double-digit percentage compared to the forecasted four to five year revenue.

And if you dare to show USD 500 MM in revenue after four years without having very strong evidence to show that such a forecast is realistic, then you are just going to look foolish.

A fourth approach that will get you in trouble in front of investors is a top-down calculation. It goes along these lines: The size of our market is X, and if we capture only Y percent of it, we can get generate staggering revenues. While it is good to show the size of your market (if you can define it well), the rest of the calculation exposes you to an obvious question: Why do you think you can capture Y percent? Why not 5x more or 5x less? Such a question is generally very hard to answer and makes you look immature in front of potential investors.

What to Follow: The Approach of Series B and Beyond

Once you've reached the Series B level and beyond, forecasting gets simpler: You already have plenty of traction and first-hand experience from your market. The robust customer and lead statistics you own give you great insights into the length of your sales cycle for direct sales efforts, conversion rates for your SaaS model, k-factor and engagement metrics for your consumer application, and so on.

Such knowledge gives you a tremendous edge when building a financial model: If I hire X new sales people, I can expect them to generate Y in revenue in Z period of time. If I invest X in marketing efforts, I get Y people signed up for my free SaaS product, out of which Z will convert into paying customers. Oh, and I will need W for infrastructure investment to support my growth.

Given the dynamic environment that every startup operates in, you will never be able to forecast for more than a year with too much accuracy. But you are in a much better position at this stage than you were while fundraising for your Series A.

How to Build a Forecast for Your Series A

It is the lack of such data at the Series A (let alone seed) stage that makes the forecasting so difficult: You are essentially trying to replicate the approach of later-stage companies without having the right information.

Marc Andreessen said in multiple discussions[17] that he likes to see companies doing nose counting: Take the potential customers you (or people in your company) know who operate in your market, estimate how much they are willing to pay, and, voila, that's your first revenue forecast. Marc is essentially speaking about building a bottom-up forecast using the information you already know about your industry. It is a great approach if you are a veteran entrepreneur who is well connected.

But what about the first-time founders who are bringing incredible technologies to their markets but don't have the necessary connections to speak with enough potential customers (i.e. most of Central European founders)? I would argue that first-time founders must approach their fundraising a bit differently, both in seed and Series A. Be prepared to devote part of your seed round for "Series A stuff"—both in fundraising size and time management. Collect as much of the "Series B data" as possible as soon as you can. Devote part of your seed round to experimenting with early marketing and sales efforts to collect the data. Yes, you don't have a product, but I hope I don't have to recite the lessons of The Lean Startup to you. Encourage the "hustler" of your early team to spend as much time talking to potential customers as possible, and try to close as many deals as you can at least in early transaction forms, such as pre-orders, signed future contractual obligations, etc.

Even such early data can aid you tremendously when building a bottom-up model. Once you have at least a basic idea of your go-to-market costs and implied revenue, building the remaining cost side of your model is relatively straightforward. I cover cost budgeting in some detail in the investment size chapter above.

Be open with your investor about the logic of your model. State all the key assumptions and methods you used to validate them. A good Series A investor understands that any forecast will be tricky, so don't be afraid to admit that there are a lot questions you don't have answers to. Ideally, try asking for specific help from the investor. If you can get the investor to help you with the forecast, you have increased your chances of getting funded substantially. We at Credo spend a lot of time with our entrepreneurs helping them build budgets and forecasts.

At the end of the day, the goal of the forecast at Series A is to show the investor that you have the right mindset and personality rather than the financial skills: If you prove that you are smart, humble, coachable, and willing to take on difficult tasks, the investor is much more likely to help and invest in you than if you bring a brilliant model but don't display the right attitude.

Section IV.
Employee Equity

13. Why Employee Equity is Important to Your Startup

Dealing almost exclusively with first-time startup founders, we at Credo tackle the following question with basically each of our CEOs: How much equity should they give the employees?

During the first conversation with a given founder about employee equity, it is not uncommon for the CEO (especially of a Central European startup) to fire back with the following question: Why would I give any equity to my employees? When I go on to say that we typically recommend a 15% stock options pool at seed / Series A stage, the CEO rolls his eyes in disbelief. When I try to illustrate that this is still pretty conservative and that U.S. VCs like Fred Wilson and Sam Altman[18] recommend at least 20%, he responds that we are not in the U.S. When I counter that he will have to compete with those U.S. startups for the best employees and exit opportunities (some CEOs are willing to give away 96% of their company to employees and investors in order to IPO on NASDAQ, such as the rather extreme example of Aaron Levie of Box), he says that can't happen to a Central European company. And he is right, if he wants to build a Central European company as opposed to a global startup.

Even though we only fund teams with global ambitions, they still have a hard time parting with their equity. Why is that? Some investors say that the size of the employee equity pools is a good proxy for measuring maturity of the startup ecosystem. Silicon Valley founders give out the most to their employees, while the mediocre European community tends to be pretty conservative. And the Central European founders, perhaps still scarred by the 40 years of forced collective socialist ownership (at least in most parts of the region), have a particularly hard time parting with their equity.

I am sure that there are plenty of other reasons for this phenomenon, so let's just say that Noam Wasserman would call many of the Central European founders kings as opposed to wealth maximizers.[19] While I don't like Wasserman's CEO replacement example (we at Credo strongly prefer the founder-CEO as opposed to a hired gun), the rest of the analogy explains well the trade-off between maintaining control and maximizing wealth.

Aside from that trade-off, what are some of the reasons why it might be beneficial for founders to part with their much-loved equity?

Advantages of Employee Equity

An important advantage of employee equity lies in its attractiveness as a hiring tool: If you are a startup with global ambitions, you have to hire top talent who also has global ambitions. These guys aren't attracted by a hefty salary; they could join a corporation for that. They want to work for the promise that if your startup makes it big, they have a shot at becoming millionaires (and changing the world along the way). This promise is especially important in immature startup ecosystems where employees might not fully understand why they would want to join a small, unproven company as opposed to a well-paying corporation.

Alignment of goals between founders and their employees is another strong benefit. A typical King-CEO worry I hear: It bothers me that my employees are leaving at 5pm and don't seem to care about the fate of the company. Well, have you tried giving them a part of the equity? Owning even a very small part of the company reinforces the feeling among employees that they are equity holders, an integral part of the team that will participate in the huge gains the company can generate if it is successful. While it may seem like a rather minor change in mindset, that feeling of empowerment can serve as a tremendous boost to your company. Having the right company culture and well-motivated employees are two of the essential factors in any startup's success.

Sometimes our CEOs tell me they feel an increase in productivity immediately after they implement the employee equity plan; not only will your employees feel a much higher opportunity cost for slacking, they will also have the urge to work in a way that maximizes the wealth of the company, as opposed to picking problems that are easy or interesting to solve but don't really add value to the startup.

Right Communication is Key

"But some of my employees don't want equity." Another standard reaction of the CEO. And he is most likely right in some cases. There are two reasons why your employees might not be interested in equity: (i) they prefer hard cash and don't want to think in the long term, or (ii) you haven't communicated the benefits of the employee equity properly.

When preparing remuneration packages, we encourage our CEOs to prepare multiple alternatives to reflect the different mindsets of your employees: equity-heavy with less cash versus more cash and less equity. These packages also reflect the different natures of employees in different departments: The sales team might have higher risk (and therefore equity) appetite as opposed to the engineering team. Each employee should have the right to choose the fitting mix based on his risk / reward preferences.

I would be wary of employees who refuse to take any equity at all: Employees with such a strong preference for the short term are typically unreliable and might cause more harm than good.

That is, unless they are refusing it because you haven't communicated the advantages of employee equity properly. You will only be able to communicate the concept of employee equity effectively if you understand it thoroughly and can explain it in very simple language. Lack of a clear understanding of the concept, its costs and its benefits is, in my opinion, one of the major reasons why startup founders in our region are so hesitant to work with employee equity. That's why the next chapter will try to explain the concept in some detail.

14. How to Structure Employee Equity in Europe

Explaining the concept of employee equity is a very difficult task. This topic is so complex and robust that it is almost impossible to pack all the relevant content into a single chapter (I could devote an entire book to it). Therefore, I have decided to use a different approach: This chapter will summarize the basic concepts of employee equity using already-existing content available on the internet (predominantly Fred Wilson's amazing series on this topic[20]) and provide some commentary and context for European startups. Please note that this chapter (for brevity's sake) will most likely not make sense unless you go through the articles (URLs are in the Citations section) as well.

The first thing to understand is that while most people associate employee equity with "options," this is not the only form of employee equity. There are actually four types.[21] Please read about them before moving on.

Here comes the first caveat of Central European startups: Every post and legal document associated with employee equity will work with the concept of shares as the means of company ownership. We know that a lot of limited liability companies in numerous Central European jurisdictions don't work with the concept of shares, but rather with percent ownership interest in the company. Credo has invested in limited liability companies across various European jurisdictions over the years, and all I can say to startup founders about the fear of not having shares for the purpose of a stock options plan is, don't worry: An experienced investor and lawyer will figure it out for you. We typically set up a stock options plan in a limited liability company as a commercial agreement (backed by contractual penalties) that mirrors the same "share-based structure" even in entities that don't work with the concept of shares. Such a "shadow" stock options plan is not visible in the commercial register, since employees don't physically own the shares, but it is enforced as a commercial agreement. The concept of stock options are explained to employees, and employees are told that they will get their money at a liquidation event or at their departure, even if they don't physically own the shares.

Four Steps to Set Up Your Plan

We typically go through a four-step process with our portfolio companies to set up the employee stock options plan. It essentially follows Fred's logic[22]:

1. Establish current valuation of the company. It is very important to be able to value your company for the purposes of the stock options plan. We typically use the valuation of the last financing round. If this valuation was established more than 12 months earlier, we typically adjust the value based on current performance benchmarked against performance at the time of the investment.

2. Prepare the vision of the company's organizational chart (both current as well as an estimate for the next 12–24 months for future hires). Include all potential employees in it, with estimated salaries for each position.

3. For each employee bracket (VP level, director level, etc.) assign an equity multiplier to the annual salary. If your VP takes 100k EUR annually and his equity multiplier is 0.5, the EUR value of his equity is EUR 50k. Fred provides some basic benchmarks for his multipliers. My only comment regarding those benchmarks is that, in my opinion, the most junior employees, such as secretaries, don't need to be part of the plan, since a tiny slice of equity is not going to be a strong motivator for them.

4. Take the EUR value of the equity (50k from the example above) and divide it by the current valuation of the company. If it is EUR 10 MM, your VP would

own 50k / 10 MM = 0.5% of the company. Repeat the same process for each position and add up all the percentages. The sum will be the total value of the stock options plan. It should hover between 10% and 20% of the company.

Notes

- It is very important to understand that by giving out options, you are not giving out company stock immediately (specifically not until an employee has the right to exercise the option): You are giving your employees an option to buy equity in your company at a pre-agreed price (the strike price) at some point in the future. Options and their advantages are explained by Fred Wilson as well.[23] The strike price is typically set by the startup's board of directors. We tend to stick to the valuation of the last financing round. You can read more about the intricacies of the strike price,[24] even though a lot of the information is relevant only for the U.S. entities. There are some alternate forms of employee equity;[25] we use them occasionally, e.g., restricted stock to attract senior hires or co-founders. Let's look at the example of our VP above: If we set the strike price at EUR 5,000,000, the VP could acquire his 50k for 25k EUR (0.5%*5,000,000). For tax purposes in the U.S., the strike price should actually be equivalent to the "market price," so in the case of our VP, he should acquire his 50k for 50k EUR. Our "shadow" stock options plan luckily does not force us to set the strike price equivalent to market price. Nonetheless, this is why appropriate communication of the stock options plan to employees is so important.
- I agree with Fred's view to communicate equity in EUR value as opposed to percentage points (he explains why). Plus, it is important to stress to employees that the value of that equity can increase more than tenfold if the startup does well. In our example, the VP can make 500k EUR on his 50k grant if the startup does well. This is why acquiring his 50k stake even for EUR 50k can be a very profitable proposition.
- It is equally important to understand that an employee doesn't get the option of buying his entire allocated pool straightaway. It is vested over time.[26] We typically use four-year vesting with a one-year cliff. Example of our VP above: Let's say his 0.5% stake is subject to a four-year vesting schedule. In such

a case, he has a right to buy 0.125% stake every year, or 0.125% / 12 every month. If the vesting schedule also includes a one-year cliff, our VP cannot acquire any stake for the first 12 months, but can acquire thirteen monthly stakes, i.e., 13 * (0.125% / 12) after the 13th month of his employment.

- I have omitted the concept of shares in my four-step plan to make it easier to explain. It is not that difficult to incorporate shares into it: When you establish your valuation, just assign a number of shares to it, let's say 100,000. So if the VP in our example owns 0.5% of the company, he owns 500 shares.
- Regardless of whether you will use shares or just percentages, it is very important to understand how dilution works.[27]
- The plan above outlines just the initial options grant. It is common practice to give employees retention grants as well. Typically, they are given out after an employee has been with the company for two or more years. To set up the retention grants, go through the same four steps outlined above, but assign lower multipliers (e.g., if you do retention every two years and initial stock grant is vested over four years, divide the multiplier by two).

This is the most complicated chapter of the book, and I am sure that forcing you to read additional material online doesn't help, either. I apologize for that, as there are entire books devoted to the topic of employee equity. Nonetheless, I hope it provides at least some guidance. While there are many alternate approaches to this concept (e.g., look at the Wealthfront plan[28]), my most important piece of advice, especially to first-time founders, is to work with an experienced investor and lawyer to set up the stock options plan. They have done it countless times before and understand all the pitfalls. After all, their knowledge of these topics should be one of the key reasons you would let an investor become part of your startup.

If you have made it all the way to this paragraph, you most likely have found the Guide at least somewhat useful, which means it has done its job. I would be grateful if you passed on the information that you found helpful and the Guide itself to likeminded people who are in search of some startup advice. The more informed and aware our community is, the more successful our small region of Central Europe can be. And hopefully that's a goal we all share.

I am sure there are tons of questions on this material and many more topics that I didn't get a chance to cover. If you want to shout out or stay up-to-date regarding my new content, please check my Twitter for new blogs @kiskandrej. Hopefully I will get to update this Guide annually as well to continue to pile the resources into a concise format. And if you every face a dilemma that seems too tough to tackle and there is no one around to help, just remember a piece of advice from one of the greatest Central European venture capitalists Eugene Kleiner (founding partner of Kleiner Perkins Caufield & Byers): The more difficult the decision, the less it matters what you choose.

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