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1. Basics of Company Formation

- Company Formation: The process by which we move from "idea" to paying people.
- How do we form a company?
  - In our case we will focus on a hypothetical company *Meow-meet* (Think Tinder for cat lovers).
- How do we build this?
  - **Problem:** We need to money to pay the following people:

Designers	Marketing
Engineers	HR/Payroll/Ops
Product Managers	Servers
Data Science	Snacks

- So how do we get it?
- **We ask!**
- What are the mechanics of asking?
  - Money Traditionally raised in discreet **Rounds**
  - Rounds have (relatively) standard names

	Name	Goal
Pre-Series	Friends and Family Angel Round Seed Round	Proof of Concept (POC)
Series (Post-Money)	A	18 Months of Runway Specific Goals: Expansion New Team New Product Specific Pivot
	B, C, ...	

- What exactly is a **Round?**
  - Generally:
    - Investors receives “Ownership” or “Control” (Usually as equity or debt)
    - Company receives Cash
  - Notice that we say “Generally” – there **a lot** of possibilities:
    - **Equity:** Think stock. This is the most common type of round.
    - **Debt:** Think of as a “loan” to the company.
    - **Convertible Note:** Usually seed / early series and allows the investor to change from different types of ownership structure (e.g. debt which gets converted to equity if some hurdles are hit OR if there are multiple types of stock this allows investors to change the class of stock that they own).
    - **Warrant:** Type of “option” or “promise.” Can be a lot of different things, such as ownership conditional of additional funding.
  - **Preference:** Different types of equity (even among stocks) can often have different rights. We differential asset classes by these rights. So there can often be “preferred shares” which have greater rights.
- More generally, investors not only want ownership, but they also want control. What does control look like:
  - **Exit / Liquidation Preference** – In the case of an exit event (Bankruptcy, IPO or acquisition) Investors want to be first in line to be paid:
    - If the company goes out of business, investors want dibs on the residual.
    - If the company get bought they want to be paid before others.
  - **Control Rights** Invest wants board seats as well as influence on high-level employee hiring
  - **Rights in future rounds** If another round is raised, what happens to my stake?
  - **Approval over financial decisions** Veto rights over future investment decisions
  - **Information about the company**
- Different investors value the above very differently.
- **Moral:**
  - Every company has their own unique experience
  - Very, very difficult to read into the details and specifics without access to the complete docs. It’s a fool’s errand (as we will see).

2. MeowMeet Example

- Friends and Family Round: Rich Uncle Jim gives us $1MM for a 10% ownership stake.
- The *implied* valuation is now 1MM / .1 = 10MM
- This generates the following cap table below

	Pct	Value
Founding Team	90%	9MM
Uncle Jim	10%	1MM
		10MM

- Simple so far, but this gets complicated incredibly quickly!
- Meowmeet launches the POC to great fanfare. Techcrunch and Venturebeat are heralding it as the future of micro-dating.
- Sequoia Capital now offers $10MM for 10% of Meow-Meet.
- If accepted the new valuation is $100MM and the cap table would be:

	Pct	Value
Founding Team	80%	80MM
Uncle Jim	10%	10MM
Sequoia	10%	10MM
		100MM

- In this case, MeowMeet received a total of $10 + $1 = $11MM dollars.
- **BUT**, Jim negotiated for the rights to sell his shares and cash out if a new investor comes in! So Jim sells half his shares and the cap table is *actually*:

	Pct	Value
Founding Team	85%	85MM
Uncle Jim	5%	5MM
Sequoia	10%	10MM
		100MM

- The math works out, but.. How much money did MeowMeet actually get? $1 + $5 = $6 MM dollars.

3. Other aspects of company formation

- Incubators / Accelerators: Programs to either create new businesses ("incubators") or to accelerate growth of existing ones ("accelerators"), though that distinction isn't as strong any more.

- They provide some combination of experience, access, networking, access to capital and space help to grow and build your company.
- Usually they do this in exchange for the right to invest in your company.
- There are speciality ones:
  Runway (Ed Tech)
  Bolt (Hardware)
  Alchemist (Enterprise)
- Famous ones:
  YC
  500 Startups
  Techstars
- Why would a company do one? It's an exchange / quid-pro-quo. Plenty of companies believe that the exchange is worth it, while others do not.

• "Down Round" - what happens when a company has a round where the value of the asset has decreased. Usually means that the company is in trouble. For example, if MM raised (after the sequoia round) money on a $50 million valuation.

• "Debt Round" – also negative. Debt has a higher preference (in the case of liquidation), so debt holders are treated above all the current investors.

• "Exit" – generally only three exists. Two have potential positive outcomes for investors while the third does not:
  (1) IPO (go public)
      Peter Thiel turned $500K in FB to $1Billion
  (2) Acquisition: when a company is bought by another company
      A16Z (who we will talk about later) turned $250K to $78MM with their investment into instgram.
      Not all acquisitions are positive (we will also talk about this later)
  (3) Bankruptcy

4. Employee Equity

• In tech companies, equity compensation is fairly common.

• Pre-exit equity compensation tends to have limited value:
  - Usually not possible to sell your equity until the company has an exit.
  - Even when there is pre-exit opportunities to turns equity into cash they tend to be restrictive and may come at a significant haircut.

• Common types of equity compensation:
  (1) **Stock:**
      Direct equity in a company. Pretty uncommon

If it's done, tends to be at company inception Or with older public companies.

(2) **RSU:** Restricted Stock Unit
Similar to a direct stock grant, but has some technical/tax advantages.
Most common type of equity compensation for public companies.
Downside is that the grantee has no control over the timing of the tax event (more on this next week!)

(3) **Option:** Option to purchase a stock, usually at a discount.
Tends to be used by smaller private companies.
There are a LOT of different ways that these get done.

- Why not just use cash?
  - Cheaper for companies
  - Can be tax advantages (for companies)
  - Incentive alignment
  - For start-ups cash may not exist

5. Employee Equity Valuation (Public Companies)

- In this section we talk about the valuation of equity for public companies
- a **Public Company** is one whose equity can be bought and sold by the public. In the US this usually means stocks that are traded on NASDAQ or NYSE.
- The value of equity can fluctuate a lot, but its current value is usually pretty easy to figure out.

(3/20/2022)	Price ($)	Shares Outstanding (MM)	Market Cap (B)
AAPL	164	16,500	2,706,000
AMZN	3,225	500	1,612,500
GOOG	2,722	732	1,992,504
FB/Meta	216	2,895	625,320
NetFlix	380	455	172,900
Twitter	37	865	32,005
Microsoft	300	7,600	2,280,000

- We can get this information because these companies are public.
- Public companies are also required to disclose additional information and financial data.
- The numbers are standardized and verifiable.
- Important documents:
  - 10K / 10Q: Annual and quarterly reports which contain information about the performance of the company. Important sections:

    (1) Item 1: Company Business
    (2) Item 1A: Risk Factors
    (3) Item 7: Managerial Discussion
    (4) Income Statement: Profit and losses of the company
    (5) Balance Sheet: Snapshot of the company's current financial situation.
  - S-1: Filling required before a company goes IPO. Contains financial data similar to a 10K/10Q, but with additional details around how the company will go public.

- For public companies, this is the information that you can use to determine the future value.
- We won't go too deep into the details during this class, but for your first assignment you are going to be required to skim over