Edge Analytics
Selling to VCs

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Edge Analytics

In the fall of 2005, Larry Sharp has several decisions to make. After three months of intensive fund raising for his company Edge Analytics, Larry finally had a term sheet from a well known venture capital firm, Silver Partners, although the terms of the deal were not ideal. The Silver Partners offer did not cover the full $3M-$5M capital that Larry decided he needed, so he had to consider additional investors to bring on as well. He also had to consider how this A round would affect the angel investors who had contributed money in the initial seed round. Edge Analytics was close to running out of funds so he had to make a decision quickly.

Background

Edge Analytics was founded in 2004 by Jason Loxley and David Norman. Edge Analytics developed an end user application performance monitoring product that enabled an IT department to understand the root cause of an end user's desktop performance product. Users frequently called into help desks to report a problem with their desktop. The user rarely knew what the problem was, but knew if his desktop application was not performing well. The help desk would log the problem and guess at what the issue was. Edge Analytics enabled the help desk worker to instantly troubleshoot the users problem by logging into an agent deployed on the user's desktop. Using Edge Analytics, the help desk person could understand the root cause of the problem – whether the problem was with a desktop application, a server application, the network, the desktop computer or storage device. Edge Analytics EdgeSight reduced the time it took for a help desk worker to trouble shoot a problem and also gave him information to solve the problem and keep it from happening again. Information included configuration problems, code dumps to triage application errors and reports indicating network and storage latency issues. The product was used to troubleshoot problems in real time but also collected historical data which could be reviewed to understand trends. The product was deployed as an agent on a user's desktop. The product was able to watch all the actions of the end user and therefore collect error information unobtrusively. The agent did consume some CPU of the user's desktop, usually between 3 and 4% of CPU cycles.

Edge Analytics product was called EdgeSight and the product fell into the category of desktop management software. Desktop management software was categorized as systems management software. Gartner estimated that the size of the systems management software business to be $1.2 (I changed this to $1.2B to match the exhibit) billion annually [EXHIBIT 1]. Included in this category was management software used to manage a variety of systems in a typical IT department – mainframe systems, servers, desktops and mobile devices. Vendors in the category included public companies like the "Big Four" management vendors – IBM, HP, CA and BMC. Public companies Citrix, Microsoft and VMWare also had offerings in this category.

Raising Funds

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Larry joined the company as CEO, working with the Founder, Jason Loxley and developer Derek Norman. When he met the founders the company was almost out of cash. Larry invested $150k in the company as a loan, to be converted to equity once he was able to get a venture firm to invest in Edge Analytics. The $150k investment enabled the company to hire another developer, Cody Marinella. Edge Analytics did not have any paying customers at the time Larry joined, but Larry had seen the product and learned how to demonstrate its value. Larry made a visit to three well known banks in New York. Two of them indicated they would purchase the product once the company released its first version. Larry and Jason discussed different pricing options and concluded that the best way to charge for the product was a server fee plus a desktop agent fee. The server fee was $25k and the agent fee was $3 per desktop. They knew that they would have to negotiate a lower agent price, especially for large enterprise deals. They targeted large enterprise customers and had a goal of $125,000 as an average deal size.

Larry and Jason worked on their investor presentation and concluded they needed to raise between $3 million and $5 million in order to hire additional developers and build out a basic sales and marketing team. They assumed they would have to give up between 40 percent and 50 percent of the company for this A round. They predicted sales of $9M by 2009 [EXHIBIT 2].

Angel Investors

Prior to Larry joining Edge Analytics, Jason had raised $500k from friends and family investors at a $5 million pre money valuation. This money was now almost gone. It was clear the angel investors would have to take a much smaller share of the company in the next round. Larry spoke with each of the investors and assured them that he would do his best to get the best terms possible for them. However, Larry did not suggest that the series A valuation would be higher than what the angels had paid when Jason had raised his initial funds. In fact, it was most likely that the valuation would be below the original, meaning a 'down round' for the angels. This would mean their percentage ownership would likely decline significantly.

Calling on venture capitalists

Larry and Jason put together a list of target investors in the Boston market. They were interested in investors with a strong background in enterprise software because of the potential customer and OEM and business development contacts they might have. Jason had already commenced discussion with Silver Partners who had said they would consider investing if Jason had found a CEO to join him. They came up with the following list:

Silver Partners

Greyrock partners

Highground capital partners

Global Capital Partners

Southbridge Partners

This first call was to Silver Partners to meet Jim Mangrove. Jim had tracked Jason and knew there was value in Edge Analytics. He seemed likely to offer a term sheet but required a presentation to both Silver's Boston and Silicon Valley partners. Jim said a few of his partners were 'not inclined to invest in desktop management software.' Jim also thought it would be likely that Larry and Jason would have to present to a few west coast CIOs who were friendly with Silver. The implication was that if a CIO had a negative view towards Edge Analytics EdgeSight that Silver would not invest.

Larry and Jason scheduled visits with the other three firms. The meeting with Greyrock went well but the partner there, Ben King, wanted to speak with beta customers and get a sense for himself whether this product would be widely deployed at major enterprises. The meeting at Highground was ok, but Larry and Jason got flustered when a partner at HighGround stated he thought EdgeAnalytics did not need to raise $5M. He offered $250k in additional seed funding. "Take a little money, do more research and come back when you have three customers. Then we will invest."

The meeting at Southbridge went very well and it looked like a partner, Manny Sale, would be willing to "work towards a term sheet." However, after the meeting, Manny called back to say that he would need approval from his partners, which would require another meeting in a month's time.

While each meeting seemed to go well, no one was willing to offer a term sheet. Rather, each firm needed to conduct more due diligence before they would put an offer down. Larry knew that the key to the process was to get one term sheet. Even if it was not a great term sheet, he could then go to the others saying he had a firm in hand willing to lead the round.

Securing a term sheet

Larry decided the best course of action was to focus on closing customers. However, with limited funding, he did not have much time to close a deal. And larger customers would demand access to Edge Analytics financial statements, which he did not want to share. Larry visited New York and called on Morgan Stanley. Morgan had been a beta site customer for Edge Analytics. There he met a number of senior people, most of whom had a positive impression of EdgeSight. Larry was unable to get a sale to Morgan but secured a few references, who were willing to speak to venture capitalists and confirm Morgan would license the software once Edge Analytics secured venture funding. With references in hand, Larry called each of the venture prospects and mentioned that representatives from Morgan would be a reference.

Larry and Jason heard back from Jim Mangrove at Silver Partners, who suggested they fly to Palo Alto to meet with Silver's partners. This was a very positive development – it meant Jim had secured conditional approval for a term sheet and meant if Larry and Jason performed well they would most certainly get the elusive first term sheet. The visit to the west coast went very well. The following week a term sheet from Silver arrived. The summary of the term sheet was:

Pre money valuation	$3 million
Investment	$1.5 million
Liquidation preferences	up to $35 million
Other provisions	valid for two weeks

The liquidation preference concerned Larry. This meant that if he grew the business and sold it for less than $35 million, all the money would go to the preferred shareholders and none to the employees, founders or option holders. While Larry thought he could build the value well beyond $35 million, he thought it prudent to plan for a smaller exit and to make sure the employees were rewarded in the event of an acquisition below $35 million.

While Larry was pleased he finally had a term sheet, he wanted to get better terms. He called Silver and told them so. Silver responded with a second term sheet that offered more money, but there were conditions on 'earning' the extra capital – namely Edge Analytics had to achieve certain goals [EXHIBIT 3]. Larry did not like tranched deals because he was concerned he might not achieve the goals. He would prefer to raise more money and be sure he didn't have to start raising capital again.

With a first term sheet in hand, Larry called on Greyrock partners and asked if they would invest in Edge Analytics along the exact terms or would they be prepared to offer a term sheet with different terms? Greyrock said they would debate amongst their partners and get back to Larry shortly.

Overall, the news from Morgan Stanley as a reference had helped greatly. Word had gotten out that Larry and Jason were raising an A round and a few new venture firms had called to ask for a presentation. Larry was conflicted. On the one hand he knew more options helped his negotiating position. On the other hand, each new firm took a fair amount of time to prepare for, present to and then follow up with.

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Highground Capital partners called to say they would like to invest, along the same terms as Silver Partners. Peter Mayberry felt the terms from Silver "excellent and quite fair to all parties." Larry felt an obligation to work with Highground because he had been associated with the firm in previous investments. He considered Peter a friend and strong ally. But Larry really did not like the terms of the Silver term sheet. No sooner had Highground called that Global partners called and agreed to invest along with Silver.

To complicate matters even further, Larry received an unsolicited phone call from Tom Mix, a partner at VentureNord, a Swedish VC. His firm was vitally interested in the analytics field and heard about Larry's company, Edge Analytics. Tom suggested that Larry come to the partners meeting this coming Monday and deliver a presentation to the partners. Tom said that they were not too concerned with valuation and would invest alongside any primary venture capitalist selected. They were prepared to take 25% - 40% of any offering along with the same terms. He requested an observer seat, but not a board set. Larry decided he would present to VentureNord given their excitement and willingness to strike a favorable deal.

Edge Analytics cash balance was now below $50k, which meant if Larry did not close a deal soon, he would have to put in more of his own money or the company would go under. What should he do? Take the Silver term sheet and invite along another investor? Decline the Silver term sheet and get a revised, cleaner term sheet from Greyrock, Highground, or Global? What deal should he propose to VentureNord? Now that he had an initial set of term sheets, should he shop the deal around to many other investors? And what would all this mean for his angel investors?

Assignment Due:

Act as Larry and develop a 10 slide sales presentation for VentureNord. Incorporate the business decision, which you as the CEO need to make on valuation. How should Larry proceed? Be sure to mention how you would respond to each of the VCs and the angel investors. How would your decisions affect the valuation of the company and your relationship with each of the stakeholders? What are the risks involved in the course of action you've selected? Be prepared to present your "sales pitch" in class. One student will be selected to present, and the rest of the class will be the "partners" of VentureNord who will ask probing questions.

Exhibit 1

Edge Analytics Addressable Market

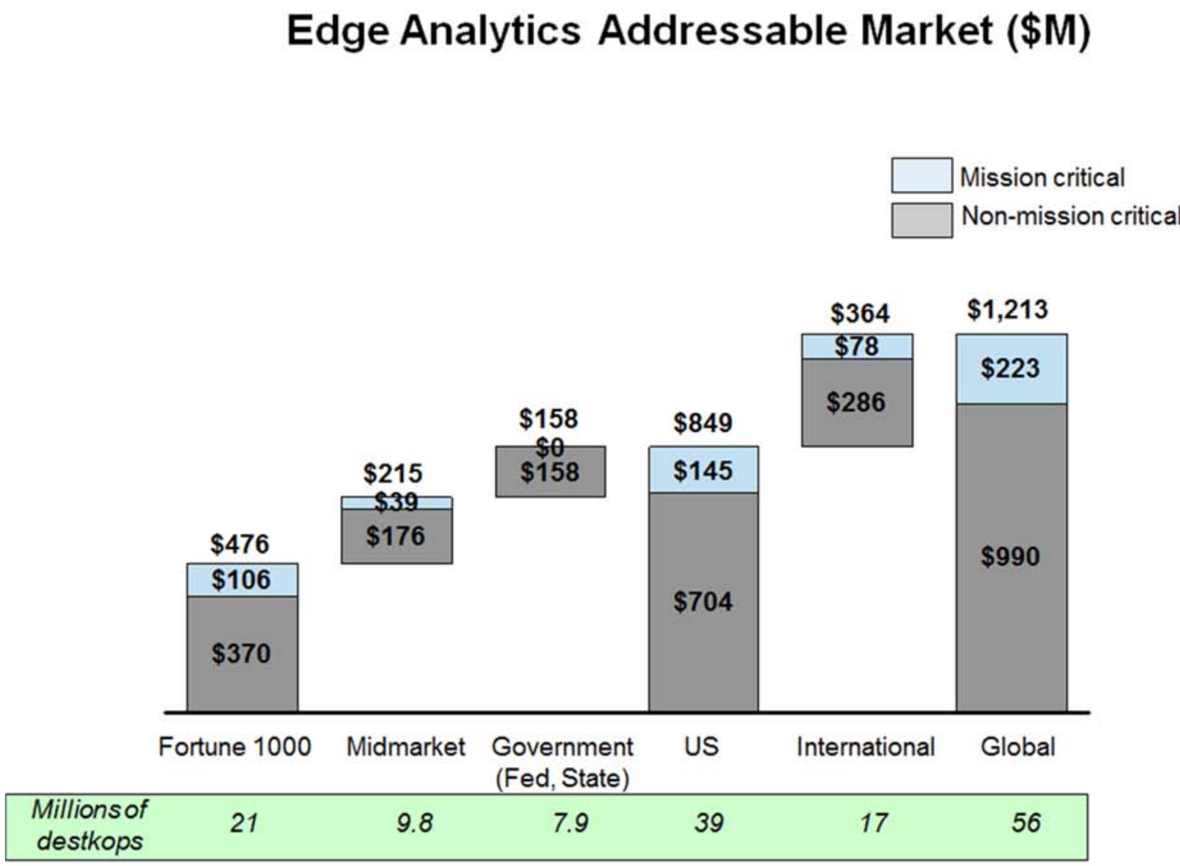

Exhibit 2

Edge Analytics projected P & L

Net bookings	1,500	3,000	6,000	9,000
Revenues	1,350	2,700	5,400	8,100
Operating expenses	2,000	3,000	5,000	7,500
Operating profit / (loss)	-650	-300	400	600
Ending backlog (Deferred Revenue)	300	500	750	1,000
Ending headcount	15	25	50	65
End-of-quarter cash and equivalents	2,350	2,050	2,850	3,450

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Exhibit 3

Edge Analytics Original Term Sheet

	original t/s		modified t/s	
	dollars	pct	dollars	Pct
Investors	$ 1,500,000	33.33%	$ 6,000,000	66.00%
option pool		40.00%		20.00%
Founders		26.67%		14.00%
		100.00%		100.00%
pre-$ value:	$ 3,000,000		$ 3,090,909	

Edge Analytics Second Term sheet

	Tranche 1		Tranche 2		Total	
	dollars	pct	dollars	Pct	dollars	pct
Investors - new $	$ 2,000,000	40.00%	$ 3,000,000	32.43%	$ 5,000,000	59.46%
Investors - old $		0.00%		27.03%		
option pool		36.00%		24.32%		24.32%
founders		24.00%		16.22%		16.22%
total		100.00%		100.00%		40.54%
pre-$ value:	$ 3,000,000		$ 6,250,000		$ 3,409,091	
		valuation step-up:	1.25			

Exhibit 4

Comparable Valuations

Company	Revenue	Valuation
Precise Software/Veritas	$76 million	$600 million
Premitech Software A	$1M	NA
KACE Software	$.3	NA

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Exhibit 5

EdgeSight ROI for large enterprise customer

Faster Problem Resolution Savings for Solution Center and DARTS Teams	$297,375.00
Operational Efficiency & Cost Savings – Technology Refresh, Memory Upgrades & Software Utilization	$1,346,500.00
SLA Management - Application Performance	$300,000.00
Total Savings for 21,000 desktops:	**$1,943,875.00**
Extended Price for EdgeSight Investment for 21,000 devices, including maintenance & training	**$651,000.00**
Breakeven Point:	**4 months on list pricing**