15.391 Early Stage Capital F10

Fact Pattern:
MIT/FIT Corporation

Summary:

You are the founders of MIT/FIT Corporation, a Cambridge-based provider of exercise monitoring equipment for gyms and healthcare benefit providers through its *BodySense* sensor products, and its *FitAnalytics* and *HealthAnalytics* software packages.

MIT/FIT has developed a patent-pending wireless solution to collect, store, and analyze the wearer's exercise and fitness data. The solution differentiates itself initially through low initial setup costs, reducing upfront acquisition costs for fitness centers 90% through the use of reusable sensors. Using this data it can provide fitness analytics that track member's fitness progress, improving membership retention. Additionally, MIT/FIT plans to leverage its valuable data to support corporate health benefit plans, which have shifted towards incentivized models that reward members for actively trying to reduce their healthcare costs.

As of today, you have pitched your company to, won over, and shaken hands on a deal with a venture capitalist. You have received a draft term sheet from them outlining the basic investment deal for your first round of venture funding. You will now be 1) meeting with your lawyer to go over the term sheet and consider legal and negotiating strategy and then 2) negotiating with your VC over a few provisions you identify as crucial.

MIT/FIT:

For the purpose of this memo, the name of your startup is MIT/FIT, Inc. ("Mi-Fi"). [You should use your own team name in all documents you prepare.] Mi-Fi is a company targeting the growing demographic of people living or aspiring to live a healthier lifestyle, and rewarding those people. A short overview of Mi-Fi's business model, in the form of an executive summary, is provided at the end of this document. (This information is provided as purely supplemental, background material for discussions with your lawyer and VC.)

Remember, by the time you've gotten to this stage, you have already sold the VC on your idea and business model; the question in this exercise is, "for what kind of preferred?"

Operating History:

You, as one of the four co-founders of Mi-Fi, brainstormed the idea for Mi-Fi during your time at Sloan. The catalyst was really a series of events organized by the MIT $100K back in the fall of 2009. One of you had developed the high-bandwidth, durable, sensor technology in an electrical engineering lab while an undergraduate student.

After a workout at the local gym, you struck up a conversation with the proprietor, who took interest in your research to see if it could improve on the expensive monitoring system he had been eyeing in the fitness journals. The existing solution was costly because sensors could not be reused. Given the high costs, he imagined that the cost of the sensor would have to be passed to the customer, but worried that the adoption rate would be slow at its current price point. The idea fired your imagination but you realized you would have to build out a team to take on the project.

As you cast about for complementary skills to your own, you brought the idea to a 100K event where you realized 3 of your Sloan classmates had a similar passion for physical fitness and personal electronics with highly relevant previous experience. In addition to you all being Boston area-based, you have all spent time over the years working in and around the digital media and fitness industries. Each of you has real entrepreneurial drive and a passion to build something on your own.

Among the four of you, you have the strong backgrounds in operations, sales, programming, internet, and hardware development to get a new venture going. With a great deal of entrepreneurial enthusiasm balanced with industry vision and experience, you began building a plan for a company to take this challenge on. And thus, while still pursuing your MBAs, you all started working part-time out of one of your basements in the spring of 2009.

Returning to the original pain that had surfaced this potential business opportunity in the first place, you approached and soon landed that Boston gym as your first customer. Your company's solution, BodySense, proved to be 90% less expensive for them to implement and more inter-compatible than comparable sensor technology. Additionally, the FitAnalytics software was far ahead of the remedial analytics software available in current packages. Sales to local gyms rocketed as positive word-of-mouth spread about the effectiveness of the product.

After graduating with your MBAs in May of 2010, you attracted 9 additional fitness centers in affluent areas along the beltway. You were generating enough service revenue that your young team of 4 moved to a tidy subleased office in Waltham. It was at this point that the part-time, "on the side" startup became a full time job .You filed provisional patent applications to begin the process of protecting BodySense and FitAnalytics intellectual property.

A Change in Health Benefits Incentives

One night over a couple of beers at Characters in late December 2009, a CNN segment on the healthcare bill recently passed by President Obama caught your attention. The healthcare bill included an amendment to allow companies to reward employees for demonstrating healthy behaviors.

Steve Burd, CEO of the nationwide grocery chain, Safeway, from which the aforementioned amendment owes its namesake, devised an unconventional benefits plan in which lower insurance premiums were given to people who maintained healthy blood-pressure, cholesterol levels, and frequent exercise. Safeway representatives also claimed that the company's healthcare costs rose only 2% from 2005-2009, compared to 40% for other companies during the same period. Building on the success of the program, Burd advocated for legislation changes and launched Safeway Health, a subsidiary that designs similar wellness plans for other companies.

You and your partners pondered how companies were able to monitor whether their employees were actually following through with their claims of exercise and realizing healthier lifestyles. Without a method to validate that employees were actually exercising or living healthier lifestyles, employees could enjoy the benefits of lower premiums while creating greater actuarial risk for the benefit plan. Conversely, others may have undertaken an exercise regimen but may have shown no change on the conventional metrics used to measure wellness. Some form of a premium reduction could be given to reward those who stuck to their exercise regiments and lived healthier lifestyles despite missing the marks on traditional metrics.

You and your colleagues believe that the data aggregated on the FitAnalytics platform could be used by company health plans to monitor and reward those employees who made *changes* to live a healthier lifestyle.

A New Potential Market and Product Line

The healthcare benefits market was over $21B in the US with the majority of insurers facing high informational asymmetries between the customer and the insurer. The healthcare informatics space was also nascent with few players providing any reliable solutions to measure people's physical fitness, or incentivize people to pursue healthier lifestyles.

At this juncture, you begin to rethink your distribution model in order to reach the masses of the population who most need the incentives to exercise. Subscribers of gym memberships are a self-selected group of 40M in the US that is already conscious of their health. In this model, those who aren't currently enrolled in gyms or health clubs are not reached.

Instead, you target distribution of the product to companies with incentivized corporate wellness plans like the one implemented at Safeway, and companies with more progressive management seen to likely implement such a program. Here you can reach an entire cross section of the population, both currently fit and non-fit. Mi-Fi's solution can provide the analytics to company plan operators to *validate* changes in member's exercise habits and lifestyle. Additionally, it can *incentivize* people who otherwise wouldn't have exercised to make changes.

Against this backdrop, you all recognized there might be a terrific business opportunity in solving this bigger problem; the entire business vision took an immediate turn.

With a strong consensus among the founders to refocus the company on the healthcare benefits market, you completed the latest upgrades to your technology and platform, and decided to pursue *HealthAnalytics*, the healthcare benefits version of the product by late March 2010. With the new focus, Mi-Fi suddenly had the potential to be a much bigger player in a much bigger market, with much better prospects.

With luck, you signed your 10th paying BodySense customer before the Summer of 2010. While the volume of Fitness Center solutions subscriptions had climbed 10x during the year and continued to pay the bills and grow the business, you expanded your focus to the Healthcare Benefits business. You all agreed to take minimal salary, and one of you actually gave up salary altogether in order to plow back all profits into further development of the transcription software and realizing this vision.

As the summer of 2010 arrived, you had resolved almost all your initial questions surrounding *HealthAnalytics* and were starting to generate significant buzz on the *BodySense* side. You had raised Mi-Fi's profile through strategic appearances at trade shows and conferences, and were building the *BodySense* brand across a broader spectrum of customers. You were poised for significant growth.

Expansion Plans and Capital Needed

To handle the growth, you hired 2 programmers, a part-time accountant, and several commission-only sales managers. (These are all necessary hires, but nevertheless a strain on your shoe-string operation.) By the end of September 2010, you are at a true moment of decision. You have set goals to sign an additional 40 healthcare facilities within 12 months to triple your client base and begin the rollout of your much anticipated *HealthAnalytics* services with an immediate focus on Massachusetts insurers and the university health plans.

To conserve capital at the outset, you all made the decision to outsource production and assembly of the BodySense sensor to a local producer. However, to increase the units of production and retain the quality necessary for adoption, you realize that investing in your own assembly facility is necessary. You expect an initial investment of around $3M to secure the lease and equipment necessary to proceed.

In addition, you will need to triple your development and operations staff and add sophisticated business development professionals. You are also very concerned about other companies entering your market, especially once you rollout *HealthAnalytics*, which you anticipate could be much bigger overall than *FitAnalytics*. It is critical that you build as much lead time as possible and continue to expand your service offerings. You cannot do that without hiring additional developers and IT staff and extending your IP reach.

In short, if Mi-Fi is to expand and continue to grow, you must have more capital. Candidly, not all of your team members are convinced that VC funding is the only way to go. They worry about the cold funding environment and the lousy terms that founders are getting, and the pressure to take less-than-desirable exits when VC funding is included. Your teammates are also not confident that the accelerated development is worth the cost in ownership and control that you will lose in Mi-Fi.

While you may have some disagreement on financing models, you are all truly committed to your process and to MIT/FIT. You believe in the value of your business model, and that you are solving an enormous problem in an innovative, win-win approach.

The bottom line is that it is now late fall 2010. Mi-Fi has had a great run of success as a young start-up. In order to move to the next stage of growth, build out your client base, and rollout next-generation products, you must decide for yourselves how to cut the best deal for outside funding.

Quest for Cash:

When you founded Mi-Fi, you all agreed and resolved to fund the company yourselves as long as practicable. You have been lucky enough to have Mi-Fi throw off some cash relatively early through BodySense. You have also resorted to many traditional forms of early stage capital: self-financing, friends and family, and credit cards.

You all attended the 2009 MIT Venture Capital Conference last December. You were encouraged to hear about the uptick in venture investment during the panel discussions. Nevertheless, your team decided you were not ready to make a persuasive approach to a VC. You've bided your time as long as you could, relying on bootstrapping.

During 2010, as operations increased, your expenses have correspondingly escalated as well. Fortuitously, one of you has been able to loan $250,000 to Mi-Fi from a spectacular futures trade by levering up on the strong gold rally during 2010. This infusion of cash has kept the company going for the first half of 2010. However, during the summer, you realized that your burn rates were increasing and that you had no option but to look in earnest for outside funding. You also realized that you had a unique opportunity to capitalize on the momentum and investor interest in your combined *FitAnalytics* and *HealthAnalytics* technology. Plugging back into the MIT alumni network, you got some excellent free advice to sharpen and better define your business model, your market, and your sustainable competitive advantage.

In September, with a revised, well thought-out business plan, you went back to a VC you had met at the MIT VC Conference last year. A well-regarded senior associate at a leading Boston firm, she was impressed by your rapid growth, recognized the immediate potential of your space, and your vision to transform the healthcare benefits industry.

You may assume that the VC has sold the concept to the firm's partners, and that they have completed their technical and market due diligence to their satisfaction. They believe in the market space, your technology and approach, and that Mi-Fi has a distinct technology that other entrants will not be able to replicate. They also believe your team can execute to plan.

To be successful, you must ramp up your company quickly. You must prove to your customers that you can satisfy their needs and offer the best quality for the price solution to customers. Furthermore, you realize that as soon as *FitAnalytics* gains momentum in the market, competition will rapidly increase.

In conversations with your VC, you have valued Mi-Fi at $7 million. You calculate you need $4 million in this round to capitalize on your current competitive advantage and execute to plan. This $4 million round will allow you to run Mi-Fi cash flow positive and to expand the company rapidly. According to your current projections, the investment should last you around 18 months. You do anticipate the necessity for an additional round, perhaps 2, to get you to profitability. The VC firm has made an offer and has presented a term sheet offering $4 million on a $4 million pre-money valuation.

You have looked it over, but think it is worthwhile to meet with your lawyer to understand it better. You make an appointment with your lawyer, an experienced Boston-based practitioner in the technology space. While you haven't thought much about legal advice since you were incorporated, you may assume that you have established a comfortable client relationship with your lawyer. You consider your deal points with your team, and then go to discuss the term sheet at your lawyer's office.

Your Jobs:
You are all co-founders of Mi-Fi, but your job titles are not pre-assigned. You should assume a **title*** that matches, or is close to, your actual skill set. In other words, what job would a start-up hire you to do? It doesn't matter if by chance your team has 4 engineers – that mirrors many real-life startups. As a practical matter, you should name someone from your team **CEO***. The lawyers and VCs will look for a decision maker. (The CEO's assumed background, however, should still be his or her actual background.) It is helpful to have a technical person or engineer (CTO or otherwise) as well. Assign other executive titles as your team sees fit.

*Note: * Items marked with an asterisk are to be assigned to team members, as discussed in the "Firm Profile" section of the "Lawyer Simulation Round" document.*

Your Legal and Financial Positions:

- You are each members of the board of **directors*** and you constitute the whole board.
- If you calculated it on an hourly basis, your salary would be just about half the minimum wage. You have all truly made personal financial sacrifices at a high opportunity cost to do BBSD.
- You have operated up until now on company revenue, pooled savings, family gifts, and credit cards.

Everybody acknowledges a few additional big contributions, as set out below:

- One of **you*** loaned the company around $250,000 from a profitable gold trade. You haven't executed a formal promissory note or anything, but everyone understands that the money was intended to be a loan and that you expect that founder to be repaid when VC money comes in.
- Another of **you*** has skipped paychecks altogether since June as a way of contributing to the financial survival of Mi-Fi. You all agree in principle that this foregone salary should be paid back when funding comes in.

Your Ownership Positions:

- The CEO owns 300,000 shares of Mi-Fi common stock.
- The rest of you founders each own 150,000 shares.
- None of you has actually paid any money for his or her stock.
- Other than what is listed above, no one else has been issued any stock, although you owe the programmers 25,000 shares each (part of their compensation deal). There is no disagreement over it; you just have not had time to get it issued.
- Everyone's stock was issued without any vesting or other restrictions
- You haven't gotten around to granting any options or establishing an option pool. It's a good idea, and you want to learn more about them; it just hasn't been a priority.

Process:

As discussed in the "Framework I: Lawyer Simulation Rounds" document, you work with your lawyer at their offices to understand legal jargon, market practice and typical negotiating ploys and strategies in term sheet negotiations. As detailed in the "Framework II: VC Simulation Rounds" document, you meet with your VC at their offices to negotiate several key provisions of the term sheet and business deal. One critical assumption: you are to assume that you are comfortable that the valuation negotiations are on track, and so have tabled discussions of pure valuation at this meeting and will take up only (so-called) on-financial provisions in the term sheet.

MIT/FIT Executive Summary

Company Overview
MIT/FIT ("Mi-Fi") is a Waltham, Massachusetts-based startup currently focused on selling a hardware-software solution through its *BodySense* and *FitAnalytics* product offering to address the growing personal demand for fitness and personal analytics. In addition, they are developing a new technology called *HealthAnalytics* to attack the huge unexploited opportunities in Healthcare Benefits Industry where information asymmetries affect both patient and provider.

Global Fitness Industry
The global fitness industry is a highly fragmented industry composed of high localized markets. The industry generates $68B in revenues globally. However, proprietors of health clubs face significant issues with membership retention. 40% of new members quit the club within one-year with lack of progress cited as one of the most prominent reasons. Operators of health and fitness center continuously look for ways to make membership "sticky" and encourage sustained membership.

Growing Obesity in the US
In the United States alone, 123 million people, nearly two thirds of the entire population are overweight or obese. This population segment is generally forgotten by the fitness industry, but is the one where fitness awareness and efforts are most needed. This segment needs regular exercise monitoring and progress reports to encourage continual healthy habits. Obesity related medical expenses are estimated to cost more than $344B each year with approximately $73B in lost productivity to society.

Changes in Health Care Benefits
Traditionally, the healthcare industry has suffered from information asymmetries between patient, payers, and providers. Payers had crude ways of estimating a person's risk with limited live data to validate assessments. However, the industry is increasingly shifting to an incentive based model. The so-called Safeway Amendment, a component of the Obamacare bill enacted in early 2010, allows employers to incentivize employees to lower their overall healthcare costs. Companies can offer bonuses and premium reductions up to 50% if they agree to health screenings, quit smoking, lose weight, exercise, and take other lifestyle practices conducive to good health.

Enter MIT/FIT

Though *BodySense*, *FitAnalytics*, and *HealthAnalytics*, MIT/FIT is revolutionizing the global health and wellness space. By creating a reusable fitness monitoring device, Mi-Fi is able to reduce the upfront costs of monitoring an individual's workout by up to 90%. Additionally, Mi-Fi provides opportunities for patients enrolled in incentivized health benefits plans to reduce their healthcare premiums through fitness credits validated by the device.

Our solution can provide fitness centers with a low-initial-cost solution to drive membership retention by providing members' workout and trending fitness analytics. We recognized the opportunity of combining a reusable sensor technology with analytics to encourage people to continue exercising and living a healthy lifestyle thus reduce monthly churn by 30%. Previously, health clubs had to run seasonal promotions, offering membership at deep discounted prices, before summer and after the holidays to encourage membership. With the *BodySense* and *FitAnalytics* solution, fitness centers receive a more steady revenue stream from month-to-month due to the return churn, and can improve margins by avoiding offering membership at deep discounts.

Our *HealthAnalytics* solution supports incentivized health benefits plans, rewarding members who make choices to live healthier lifestyle. We monitor member's workouts and progress along their fitness programs. This data is used to reward members, who take active measures to reduce their healthcare costs, with premium discounts up to 50%. Our trending data ensures providers that members are following through with their goals and help to de-risk the pool of insured. Additionally, it encourages members to attain their fitness goals. By supporting preventative fitness measures, *HealthAnalytics* helps to reduce the overall healthcare costs of company health benefit plans.

MIT/FIT's competitive landscape has many players operating in segments of the market, but few covering the end-to-end service that Mi-Fi aspires to provide. Established companies like Life Fitness and Star Trac that make fitness equipment with embedded analytics form one corner of the market. In the other corner, personal fitness sensors manufacturers, including those incorporated in the NikePlus to generic pedometers, deliver the closest competitive product. However, neither provides the personal analytics and fitness club-based solution, or the healthcare solution that Mi-Fi will provide.

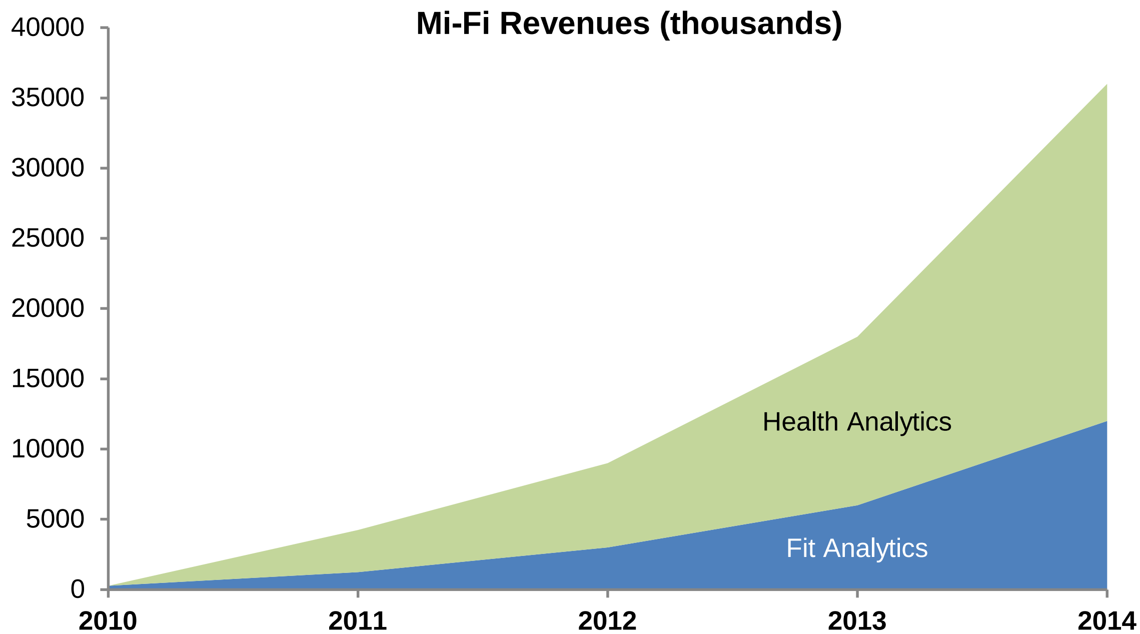
Revenue Model
MIT/FIT sells it services in the B2B market directly to health clubs who potentially use the fitness device. They institute a two-part tariff with an initial sign-up fee of services.

Fit Analytics

- *Installation Fee:* One time installation fee of $5,000 for a multi-license package up-to 100 sensors, wristbands, and chargers
- *Recurring Fee:* Each health club will be charged a per-seat charge of $0.50 per user per month. An average health club should anticipate spending around $700 per monthly for the service

Health Analytics

- *Recurring Fee:* $0.25 per month per individual under company health care benefits plans



Funding Needs
Mi-Fi has met and exceeded its initial goals. We have an existing operating business in the wellness monitoring at individual fitness centers. We have established trusted client relationships with local health-clubs and actively pursuing relationships with large nationwide fitness centers. We have also completed the development of our analytics platform and upgraded our back-end infrastructure to meet the proposed increase in customer demand.

Mi-Fi's business plan calls for two phases of major investment to meet the demand of additional customers:

- Launch new *HealthAnalytics* product for the healthcare benefits industry. Mi-Fi has identified two providers: the MIT HMO program and Safeway, who are interested in testing this product
- Build production capacity to scale both the *BodySense* and *FitAnalytics* fitness center solution, and the *HealthAnalytics* provider solution. As the company evaluates new markets, it expects to scale its customers rapidly and needs to secure the assembly facilities to provide products to match demand

With the prospects of two fast growing products, *FitAnalytics* and *HealthAnalytics*, Mi-Fi is poised for strong growth, riding on the momentum of successful incentivized health benefits plans. Mi-Fi's initial success with *FitAnalytics* has fueled its confidence in success with *HealthAnalytics.*