



*The Classic Value Story*

*Had you purchased a single share of Cisco Systems in February 1990 for \$22, your investment February 2011 would be worth over \$2,657.*

High quality employees are the very lifeblood of today's successful companies. For this reason it is critical that founders and management know how to attract and retain people who are committed to a shared vision of company growth. The vexing question may be how does one create commitment? It is not just a natural trait, but often a response to critical motivators like a sense of shared ownership, personal reward, and the opportunity to participate in building a successful company. What is the key to unlock these motivators? Valuable stock options.

What makes a stock option valuable is the value of the company, so it's important that all employees be focused and aligned on increasing and maximizing this crucial metric. After all, which is more valuable—twenty percent of a bankrupt company or half percent of a company with a market capitalization of \$1 billion?

This white paper is intended as a primer on the value of a start-up company, how value is reflected in the share price and how to resolve the dilemma of dilution as funding and staffing are increased. It illustrates some of the important issues of stock valuation including critical calculations, and why company value is the super ordinate goal. However, the treatment is intentionally simplistic and readers should consult with their CPA, attorney, and stock plan consultant to develop their own cases.

To illustrate the points of interest, the following scenario describes a fictional start-up company and shows how the owners deal with some of the questions of stock and value as they progress from start-up phase to an IPO. The example does not represent a typical case, but is rather a compendium of some of the perplexing problems that founders might face.

A pre-revenue company whose owners cannot fund product development, marketing and staffing will often need "outside investment." They must consider how much money is needed and select the most favorable sources. For high technology companies, the primary source is venture capital. The amount of investment is determined by financial projections and may take anywhere from one to four infusions. Very often the total investment will require selling more than half the company and, hence, giving up control. Therefore, there needs to be careful consideration about how much money to take and when to take it.

With each infusion, which is called a "round of financing," founders and managers may face difficult questions, some of which will have a direct bearing on their personal wealth. It is important, therefore, to understand how the investment increases the value of the company, now or in the future, and what the investment will cost. As the example illustrates, the cost of capital can sometimes result in loss of control and will certainly result in a reduction of ownership.

### **A Fictional Study: Stock Ownership, Value and Dilution**

Imagine that five people start a company that intends to provide a knowledge management tool to help criminal justice agencies solve crimes. The unique selling proposition will be the ability to convert data to knowledge, and then use AI techniques to develop scenarios for how a crime may have been committed. Financial projections indicate a need for a \$10 million investment to complete product development, initial marketing and staffing.

## STOCK OPTIONS

### Market Valuations

The explosion in e-commerce requirements has spawned a new breed of consulting company that combines traditional IT skills, internet skills, cloud computing, and the necessary business skills to know how to implement e-commerce sites. The stock market sees great potential in these companies as reflected in their share price.

Take, for instance, Rackspace Hosting Inc. This company went public in August of 2008 and raised \$145M at its IPO. The second quarter of 2010 its revenues were approximately \$187M. Annualized, this would be \$748M. The company's market capitalization was approximately \$2.2B which gives a ratio of value to revenue of 3.

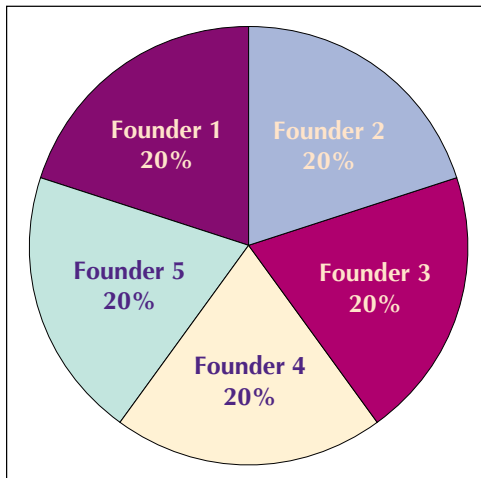


Chart 1: Founders' Ownership

### The Seed Round

The five founders enlist the help of an executive coach to help them think through the important issues in starting and managing their new company. The coach begins by counseling them on developing their vision, goals, and objectives and then reviews the stock structure and ownership.

As part of their visioning process they agree on a number of common "outcomes," one of which is that they each want to become financially independent as a result of this venture. With this in mind, their preferred goal is to create a publicly traded company, which means planning for an IPO.

With regard to each founder's company ownership, their coach suggests that before any other stock is sold or promised, they must make an agreement on the number of shares each founder will own. He argues that delaying this until after the company has grown or other people are involved can create friction among founders.

They incorporate as a "C" corporation and authorize 21 million shares. Each person agrees to make an initial investment of \$20,000 with a share price of 2 cents, giving each founder 1,000,000 shares (see Table 1). This is the seed investment of \$100,000.

Investors	# of Shares	Share Price	This Round Investment	% Ownership	Current Value
Founder #1	1,000,000	\$0.02	\$20,000	20%	\$20,000
Founder #2	1,000,000	\$0.02	\$20,000	20%	\$20,000
Founder #3	1,000,000	\$0.02	\$20,000	20%	\$20,000
Founder #4	1,000,000	\$0.02	\$20,000	20%	\$20,000
Founder #5	1,000,000	\$0.02	\$20,000	20%	\$20,000
Total	5,000,000		\$100,000	100%	\$100,000

Table 1: Founding Investment: The Seed Round

The coach, with an eye on quickly building company credibility, suggests that they form a board of directors comprised of two of the founders and three industry/business experts to assist in guiding their decision-making.

## STOCK OPTIONS

*The technically biased founders are keen to start product development, but their adviser stresses the need to always try to anticipate future financial requirements.*

### The First Round

The technically biased founders are keen to start product development, but their adviser counsels that the seed money will quickly be consumed and stresses the need to always try to anticipate future financial requirements. Two of the five founders take responsibility for seeking and raising additional funding while the others begin product development.

Through their networking and PR activities the two founders find a venture capitalist (VC) who will invest \$10 million in the first round, but with conditions. He thinks the product idea is good and the founders technically strong, but the team lacks management skills. He offers the investment on the following conditions:

1. Bringing in key managers, including a CEO, CFO and VP of Sales and Marketing.
2. Ownership of 51 percent of the company. The VC wants to reduce the investment risk by retaining control of important strategic and financial decisions.

Note that after this first round investment, 51 percent of the company is valued at \$10 million and, hence, the value of the company is now approximately \$20 million (see Table 2).

Investors	# of Shares	Share Price	This Round Investment	% Ownership	Current Value
Founder #1	1,000,000			10%	\$2,000,000
Founder #2	1,000,000			10%	\$2,000,000
Founder #3	1,000,000			10%	\$2,000,000
Founder #4	1,000,000			10%	\$2,000,000
Founder #5	1,000,000			10%	\$2,000,000
VC #1	5,204,082	\$2.00	\$10,000,000	51%	\$10,408,164
Total	10,204,082		\$10,000,000	100%	\$20,408,164

Table 2: First Round: Post-Money

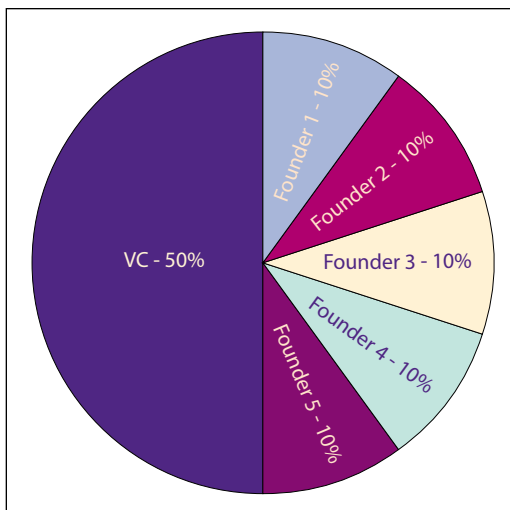


Chart 2: First Round Ownership: Post-Money

*Most investors consider the team to be by far the most important—common sense dictates if the team has good business sense, they will be in a good market with a good product.*

### Valuation and First Round Funding

The founders discuss with their advisor how much of the company they will have to sell for the \$10 million. Unfortunately for our fictitious team, they lack management skills and a track record of starting and building companies. Investors focus on: i) The Team, ii) The Market, and iii) The Product Idea. Most investors consider the team to be by far the most important—common sense dictates if the team has good business sense, they will be in a good market with a good product. The value the founders bring is reduced because they do not have a strong management team, and this is reflected in the investor demand for 51 percent of the company.

So now the founders are faced with the opportunity to get the investment they need, but it will cost them control of the company. What should they do? For some people this can be a hard decision, one that should clarify their commitments. Their adviser points out that they still have a lot to learn about running a company and much of that can be acquired in the current enterprise. He suggests that if they can successfully grow this company and take it to an IPO, it will leave them with the experience and the resources to start other companies. In effect they are getting paid to learn and still have an opportunity to significantly increase their personal wealth. The cost is giving up control. After long deliberations, they decide to accept the funding offer.

### Dilution

Selling part of the company creates dilution of ownership. After the investment, each founder's ownership share has been reduced from 20 percent to 10 percent, but the value of their holdings has not changed. Each now owns 10 percent of a \$20 million company, whereas previously each owned 20 percent of a \$10 million company. In the future, as the value of the company increases, so will each founder's stock value.

Investors	# of Shares	% Ownership
Founder #1	1,000,000	8%
Founder #2	1,000,000	8%
Founder #3	1,000,000	8%
Founder #4	1,000,000	8%
Founder #5	1,000,000	8%
VC1	5,204,082	43%
CEO	800,000	7%
CFO	500,000	4%
VP S&M	500,000	4%
Total	12,004,082	100%

*Table 3: Dilution Effect of Adding the Management Team*

Dilution may appear at first sight to be an undesirable sacrifice, but that perspective is very limiting and can sometimes restrict a company's growth. There are two factors which need to be carefully balanced when selling part of a company: the amount of ownership sold, and the value which is bought by the sale. The goal is to make sure that when stock is sold, the dilution effect is offset by an increase in company value. For example stock may be sold in return for an infusion of capital, the addition of key employees, or the addition of some critical asset like a strategic partnership.

## STOCK OPTIONS

*The goal is to make sure that when stock is sold, the dilution effect is offset by an increase in company value.*

The addition of the new managers is a good example of dilution bringing increased value. Three key managers are to be added to the team: a CEO, CFO and VP of Sales and Marketing. Since each of the managers hired has previous start-up experience, they will expect to make a substantial amount of money over and above their normal compensation. The total equity required to capture these three critical managers is 15 percent. Table 3 illustrates the result of adding these managers to the ownership list.

What is not shown “on paper” is the value that this team has added. This might easily be seen by considering future investment requirements. When more money is needed, new investors will take a strong look at the management team. It must meet some minimum requirements; but above that, the more prestigious the team, the more likelihood of a higher future valuation.

### Stock Incentives

Attracting and retaining new employees will require a stock option plan. As part owners of the company, people can feel that their efforts are making a difference, both to the company and to their own net worth. This provides great motivation for employees to make maximum possible contribution.

Unlike founders’ stock, the options program provides an opportunity for employees to capitalize on the growth in value of the company without such a high risk and high degree of commitment. With a stock option plan, employees are granted the option to buy stock at a fixed price. When the shares are traded on a public market, if the share price rises above this purchase price, there is an opportunity to realize substantial gains. Such options usually “vest” over a period of time, allowing employees to buy their options at the set price once they are vested. By setting this vesting period in the future, the company can use “Golden Handcuffs” to retain the committed contribution of employees.

These “golden handcuffs” are important in the attraction and retention of key talent. It is important to note that such stock options are created by setting aside a pool of shares from which options can be allocated. The dilution effects of such a pool are shown in Table 4.

Investors	# of Shares	% Ownership
Founder #1	1,000,000	7%
Founder #2	1,000,000	7%
Founder #3	1,000,000	7%
Founder #4	1,000,000	7%
Founder #5	1,000,000	7%
VC1	5,204,082	37%
CEO	800,000	6%
CFO	500,000	4%
VP S&M	500,000	4%
Options Pool	2,000,000	14%
Total	14,004,082	100%

*Table 4: Dilution Effects of Adding the Options Pool*

*As part owners of the company, people can feel that their efforts are making a difference, both to the company and to their own net worth. This provides great motivation for employees to make maximum possible contribution.*

### The Second Round

Product development continues, but as so often happens, challenges arise and the company misses deadlines. This delays the product roll-out, which in turn delays initial revenues. Now the company faces a cash flow problem as well as a lot of strategic problems, such as losing market share because they will be late to market. The investor insists that it's important to get into the market as early as possible, and requests a revised business plan showing how time lines can be moved up with the additional funding. The new plan indicates a need for an additional \$15 million investment. In spite of founder objections about further dilution, the board agrees to seek the additional funding; this is the second round.

### Valuation and the Second Round

Once again the board has to estimate the value of the company so that it can set a share price for the second round of financing. Since the company has met key development milestones and has an experienced management team, the risk of the investment is being reduced. This leads the board to expect a significantly higher company valuation. Significant signs of success might be demonstrating that the technology can be productized, that beta site customers are being signed up, and that no unforeseen significant problems have been discovered. The board assesses that although there is slippage in the development schedule, everything is going according to plan, and they decide to offer shares at \$6. Notice how the price to get into this deal has escalated from the original 2 cents with high risk, to a present \$6 with much reduced risk.

The initial investor decides to put a small amount into this next round, but asks the team to seek another investor to help spread the risk. The experienced management team has little trouble securing this additional investment. Table 5 shows the resulting dilution when this second investment is completed. It is important to note that the table shows a theoretical value of the stock; however, since there is no market on which to sell these shares, this is an “on paper” value.

Investors	# of Shares	Share Price	This Round Investment	% Ownership	Current Value
Founder #1	1,000,000			6.06%	\$6,000,000
Founder #2	1,000,000			6.06%	\$6,000,000
Founder #3	1,000,000			6.06%	\$6,000,000
Founder #4	1,000,000			6.06%	\$6,000,000
Founder #5	1,000,000			6.06%	\$6,000,000
Management	1,800,000			10.91%	\$10,800,000
Option Pool	2,000,000			12.12%	\$12,000,000
VC #1	5,204,082			31.53%	\$31,224,500
VC#2	2,500,000	\$6.00	\$15,000,000	15.15%	\$15,000,000
Total	16,504,082		\$10,000,000	100%	\$99,024,500

Table 5: Second Round: Post-Money

### Mezzanine Round

The company completes development, launches the product, and receives very good market acceptance. However, the cost of rapid growth starves cash flow—a common problem with emerging companies—and the company goes back to the private placement market for a mezzanine round of funding.

## STOCK OPTIONS

*One of the skills in navigating a company from start up to success is to reach a position in which the revenues exceed the total of the expenses, cost of future development, and required profits.*

One of the skills in navigating a company from start up to success is to reach a position in which the revenues exceed the total of the expenses, cost of future development, and required profits. Until that point is reached, the expenses must be covered by investment. Our fictitious company has consumed all its investment money completing product development and launching the product. Now there are insufficient revenues to “cover expenses.” This is a paradox because they are growing rapidly, have plenty of orders, and yet will not be able to pay their expenses without further investment.

The root cause of the problem is that the cost of increased marketing, expanded sales channels, and additional operations is more than the growing revenue can support. Eschewing other alternatives, the board decides their best option is to go back to the private market for another round of investment—a mezzanine round. They anticipate that this final investment will give enough momentum to make the company self-sufficient and position it for an IPO.

The mezzanine round is completed raising \$9 million at \$9 a share. Notice that if we price all outstanding shares at \$9, then the value of the company is approximately \$146 million. With sales at \$50 million per annum, this gives a ratio of value to revenue of approximately 3:1, currently a conservative figure for a company with a “hot” product. In addition, the value of the founders’ stock has increased considerably; compare Table 6 with Table 1 to see the increase in valuation.

Investors	# of Shares	Share Price	This Round Investment	% Ownership	Current Value
Founder #1	1,000,000			5.71%	\$9,000,000
Founder #2	1,000,000			5.71%	\$9,000,000
Founder #3	1,000,000			5.71%	\$9,000,000
Founder #4	1,000,000			5.71%	\$9,000,000
Founder #5	1,000,000			5.71%	\$9,000,000
Management	1,800,000			10.28%	\$16,200,000
Option Pool	2,000,000			11.43%	\$18,000,000
VC #1	5,204,082			29.73%	\$46,836,700
VC #2	2,500,000			14.28%	\$22,500,000
Investors	1,000,000	\$9.00	\$9,000,000	5.71%	\$9,000,000
Total	17,504,082		\$9,000,000	100%	\$157,536,700

Table 6: Mezzanine Round: Post-Money

The applications for the product are far wider than first anticipated and the company grows more rapidly than expected, but this brings new concerns. The company must now defend its position and attempt to stop any competitors from developing a “beachhead” into the market. To fund future investment opportunities the company decides to seek a further capital infusion through public investment. With this action the founders will complete one of the “outcomes” they envisioned when the company was started.

### Initial Public Offering

Becoming a publicly traded company brings significant changes, not the least of which is that in the future the results and operations of the company will be exposed to public scrutiny. The process of raising public money is also vastly different from a private placement. The company must find an

*The most critical factor for the offering will be the condition of the market.*

investment bank to underwrite the offering and manage the offering process. In this case, the board started interviewing investment banks early in the life of the company and has already selected and built a relationship with its first choice.

The most critical factor for the offering will be the condition of the market. Stocks of different types move in and out of favor so it is important for the IPO to occur when there is a strong demand for similar stocks. If the demand is weak, the initial share price can be depressed. Clearly, the bank cannot control the market, but prior to the IPO it does “show” the company to the market through a limited number of presentations in a nationwide “road show.” This process is intended to help create a “market” for shares of the newly public company.

The timing turns out to be good; in the two months prior to the offering several other companies with similar technologies have come on the market at \$18 a share and higher, and all analysts who follow this field are “bullish” on these companies. Anticipating strong demand the investment bank sets the initial price at \$20 a share for an offering of 3 million shares. Their acumen is fulfilled; the offering opens at \$20 and has risen to \$25 a share by close of market on the first day’s trading. The summary of the new valuation at the IPO is shown in Table 7.

Investors	# of Shares	Share Price	Initial Investment	% Ownership	Current Value
Founder #1	1,000,000	\$20.00	\$20,000	4.88%	\$20,000,000
Founder #2	1,000,000	\$20.00	\$20,000	4.88%	\$20,000,000
Founder #3	1,000,000	\$20.00	\$20,000	4.88%	\$20,000,000
Founder #4	1,000,000	\$20.00	\$20,000	4.88%	\$20,000,000
Founder #5	1,000,000	\$20.00	\$20,000	4.88%	\$20,000,000
Management	1,800,000	\$20.00		8.78%	\$36,000,000
Option Pool	2,000,000	\$20.00		9.75%	\$40,000,000
VC #1	5,204,082	\$20.00	\$10,000,000	25.38%	\$104,081,000
VC #2	2,500,000	\$20.00	\$15,000,000	12.19%	\$50,000,000
Investors	1,000,000	\$20.00	\$9,000,000	4.88%	\$20,000,000
Public Sale	3,000,000	\$20.00	\$60,000,000	14.63%	\$60,000,000
Total	20,504,082		\$94,100,000	100%	\$410,081,000

*Table 7: IPO Valuation*

The company has now raised an additional \$60 million for future growth and expansion. In addition, anyone who owns shares now has an opportunity of selling them in order to realize personal gain; however, this is done with some caveats:

1. After an IPO, SEC regulations require that insiders cannot sell stock for six months.
2. When insiders sell stock, then others outside the company might ask why this person wants to sell if it represents a good investment. Thus, selling stock can send the wrong signals to the public market and depress the share price. Notice in the example that the shares for the public market did not come from existing shareholders, the intention being to send a strong signal to the market that “this is a valuable stock, and knowing what I know I expect it to rise to much higher value in the future.”

*Stocks of different types move in and out of favor so it is important for the IPO to occur when there is a strong demand for similar stocks.*

### Summary

The example illustrates some of the key points to think about with regard to financing a start-up company, building value, and allocating stock ownership. Points of particular note are:

1. When you make stock allocations, balance the dilution and the corresponding value you are buying. Make projections for several rounds of funding to estimate what will be needed in the future. Founders are often shortsighted in their initial stock grants to employees and give away too much, too early, without a real valuation of the company. Evaluate each dilution in terms of the future value it will bring.
2. Do some soul-searching and ask yourself how much control you need. Can you continue managing and leading your company even if you do not have the majority of voting shares at the board level? Be careful with this issue. A “for profit” business, in most cases, never gives any one person complete control. Even where a business is owned by one person, they are still accountable to customers—there is no absolute control. Can you work with the investors and any new managers who might join the company?
3. Complete all stock negotiations and ownership issues among founders at the outset of the company to avoid any disagreements later on.
4. Make allowance for future stock options to provide incentives for new and existing employees.
5. Focus on increasing the value of the company. Make this the super ordinate goal and have it permeate every employee’s vision of the future of the company. Note that, of necessity, this discussion only considers the “wealth” side of the rewards for starting a company. Other factors (fulfillment, vision, passion, an interest in growing companies) may play an important role in decision-making, but their consideration would make this discussion unnecessarily complex.
6. Business plans usually underestimate the amount of money required to complete product development and get to market. Think carefully about projections. Try to avoid increasing numbers by percentage, but rather think about the constituents of the expenditure or revenue and estimate how much is required.
7. Be realistic in making market penetration/sales growth projections. Use “S” Curves to help think about market ramp up and exploding growth. This is particularly important when thinking about cash flow, which is the “lifeblood” of a start-up business.

*Founders and management must focus on maximizing the value of the company at all stages of its growth.*

### In Conclusion

One of the motivators for founders and employees of a high tech startup is to make significant amounts of money from the appreciation of company share price. To reach this goal, founders and management must focus on maximizing the value of the company at all stages of its growth. Dilution appears at first sight to be a negative effect, but instead should be seen as an investment process in which every time the stock is diluted there is value added to the company.

Stock options to new employees should be based on clear expectations that these new team members will increase the value of the company through their contribution. Taking additional investment or granting stock for strategic partnerships should be viewed through the “lens of added value.” To help with the decision making process, simply ask the question, “If it doesn’t add value, why are we doing it?” This philosophy of adding value can percolate down through all parts of the company to all employees. As owners they can be directly involved in asking questions about how the investment of cash or stock will increase the company value. In their own role in the company they can be asking themselves, “How am I adding value to this company?” which is a far more powerful question than, “Did I do my job today?”

The bottom line is value, and if you are not delivering value, then why are you in business?

### Reference Sources

The Wall Street Dictionary, Robert L. Shook & RJ Shook. New York Institute of Finance.

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### Information Sources

[www.myStockOptions.com](http://www.myStockOptions.com): A web site for people who have stock options; provides information and calculation tools.

[www.edgar-online.com/ipoexpress](http://www.edgar-online.com/ipoexpress): Part of the EDGAR reporting system which gives information on IPOs.

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### Glossary of Terms

**Authorized Stock:** The maximum amount of stock a corporation may issue. The fixed amount is stated in the company's certificate of incorporation.

**Face Value:** The amount of money for which a share can be redeemed in cash.

**First Round Funding:** The first major investment in a company; usually follows the seed round. Used for initial development.

**IPO:** Initial Public Offering

**Issued Stock:** The total number of a company's publicly held stock shares plus the number of shares the company holds as treasury stock.

**Market Capitalization:** A company's worth as indicated by the price of its outstanding shares of stock.

**Mezzanine Round:** A pre-IPO round of funding. The stage of a company's development just prior to its going public, in venture capital language. Venture capitalists entering at that point have a lower risk of loss than at previous stages and can look forward to early capital appreciation as a result of the market value gained by an initial public offering.

**Outstanding Stock:** All of a company's ownership shares of stock that have been publicly purchased or that are owned by the company's officers/employees. Shares that the company has repurchased are considered outstanding stock.

**Par Value:** A stock certificate's face value.

**Preferred Stock:** Stock shares that represent a portion of ownership in a company. These shares normally carry fixed dividends and claims. In start-up companies with VC investments, it is the claims which are important. Preferred shares are usually purchased at a much higher price than common shares and carry rights intended to help protect the preferred shareholder. The ratio of the price between common and preferred can be a complex issue with income tax implications and is beyond the scope of this paper.

**Second Round Funding:** The investment made after the first round. Often used to complete development and begin marketing a product. In many situations this round precedes an IPO or Mezzanine Round.

**Seed Round:** The first money put into a new business venture, usually directly from the founders or a loan.

**Share:** A single stock unit that represents a portion of company ownership.

**Stock:** A unit of company ownership.

**Stock Split:** Occurs when stock shares are divided into a smaller or larger number of stock shares. As an example, a company may issue a two for one split in which every shareholder would receive two shares for every share they turned in, and the par value of a share would be halved. When the number of shares is reduced, this is called a reverse split.

**Treasury Stock:** Stock a company issues and then buys back, at which time it is placed in the company's treasury where it earns no dividends and carries no voting privileges. It is included in the count of "Issued Stock."

**Underwriting:** Investment Bankers assume the risk of buying new issues of securities from a corporation and distributing them to the public. Underwriters profit from the difference between the purchase and selling price.

**Vesting:** Rights an employee receives for working at a company a specified length of time. The rights normally include such things as pension payments, participation in stock plans, and profit sharing. The term is often associated with the period that it takes for an employee or founder to have the right to own the shares they have been granted. As an example, an investor may want to keep a founder working at a company for a certain period, say four years. To accomplish this, the investor might insist that as part of funding, the founder would become entitled to 25 percent of their shares every year, thus it takes four years to own the stock. Sometimes this can be done retroactively; that is, even if the founder put up the seed money and owns the stock, there can still be a period of “re-vesting.” This process is often referred to as “Golden Handcuffs.” For employees, the same process is often applied; their stock options might vest over a number of years.

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