



## DROPBOX – SERIES B FINANCING

*The fact is fundraising is really a means to an end and not the end itself....the objective is really to build a great product that can reach a lot of people, not to raise a bunch of money.*

—Drew Houston, co-founder and CEO, Dropbox

In mid-2011, as global markets corrected amid worldwide economic uncertainty, Drew Houston, co-founder and CEO of Dropbox, the fast-growing file synchronization and sharing company, found himself in a difficult, albeit enviable, situation. Houston, who had already raised over \$7 million through two rounds of venture funding (one seed round and a Series A round) and developed a large and growing user base, began receiving significant investor interest. With positive cash flows and profitability achieved, additional financing was not necessarily needed. However, in order to pursue future strategic efforts, Houston knew that additional cash was essential. After all, Houston and his team had already successfully executed the freemium<sup>1</sup> business model but they had a greater vision—one that included a “path” to one billion users.

In order to achieve this goal, the team delineated a number of strategic initiatives. First, they looked to extend their popular consumer product to the enterprise segment, an area already being served by another start-up, Box.net, which had raised nearly \$80 million from leading investors. From there, the plan was to open up a platform upon which to allow third-party developers to add services and applications in order to build scale. In a similar manner, the Dropbox team was looking for ways to augment the consumer side through distribution partnerships—a strategy the team had earlier abandoned in order to maintain focus on the product. Finally, with the proliferation of mobile computing, the team needed to find a way to transition itself from a web-

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<sup>1</sup> Freemium is a combination of the words “free” and “premium.” It refers to a business model whereby a basic product or service (often digital) is provided free of charge, but money (a premium) is charged for additional features or functionality. For further information on the freemium business model, see “Dropbox,” GSB No. E-471.

Jaclyn Foroughi, CFA, Theresia Gouw (MBA '94), and Professor Ilya A. Strebulaev prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. The authors wish to thank Pejman Nozad, Sequoia Capital, Accel Partners, and Index Ventures for their contributions to this case.

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based company to one that could service cross-platform mobile devices. Taking the competitive landscape into account, the team realized that they would need a robust balance sheet to compete with well-established industry leaders such as Google, Apple, Amazon, and Microsoft. Likewise, they would need to focus on strategic hiring initiatives and key acquisitions in order to carry out these goals.

With several term sheets on his desk, Houston had a lot to consider. While he had ideas for the use of proceeds, he still needed a clear plan to execute each initiative. In addition, he needed to figure out how much financing to raise, at what valuation, and which terms were most important to him. Finally, with so much investor interest, Houston had to select the right investors with whom to partner.

## DROPBOX HISTORY

### Founding

The son of a Harvard-trained electrical engineer, Houston was introduced to computer programming at a very young age. He began programming in BASIC<sup>2</sup> at age five and then taught himself C programming language by studying the source code for a text-based online game. At age 14, he was hired as a network engineer by a game company after he uncovered security-related bugs in a beta-version of a computer game he signed up to test.

With perfect SAT scores, Houston was accepted to Massachusetts Institute of Technology (MIT), where he co-founded Accolade, an online SAT<sup>3</sup> preparation company. Accolade was bootstrapped and profitable, but after graduation in January 2006, Houston left the company to work for Bit9, a security software start-up headquartered in neighboring Waltham, Massachusetts (see **Exhibit 1** for Dropbox's timeline from 2006 through 2011).

In the summer of 2006, one of Houston's younger fraternity brothers, who had been working on a start-up idea for only a couple of months, left Massachusetts for the Silicon Valley "where the real action was happening."<sup>4</sup> This gave Houston the motivation to pursue his own entrepreneurial dream. Three months later, while waiting for a bus from Boston to New York City, Houston realized that he had forgotten his USB flash drive<sup>5</sup> back at his apartment. While Houston attended MIT, he could access his files from any computer connected to the school's computing environment, so forgetting a thumb drive would not have been an issue. Frustrated, he wondered why the "real world" didn't have a similar means of file storage. With nothing else to do on the four-hour bus ride, he began writing the first lines of code that would later become Dropbox.

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<sup>2</sup> BASIC stands for Beginner's All-Purpose Symbolic Instruction Code and is a general-purpose, high-level programming language.

<sup>3</sup> The SAT is the most widely used college admissions exam in the U.S.

<sup>4</sup> Drew Houston, "Drew Houston's Commencement address," (speech, Cambridge, June 7, 2013), MIT, <http://video.mit.edu/watch/mit-commencement-2013-speeches-24832/> (June 12, 2014).

<sup>5</sup> A USB (Universal Serial Bus) flash drive (or thumb drive) allows for mass storage of data and then transfer of that data to a connected computer or device.

## Early Funding

### *Pre-Seed Financing*

Because he was still employed by Bit9, Houston continued to develop his file synchronization and sharing idea on a part-time basis. Still, he was able to complete a prototype of the product just one month later. By the spring of 2007, Houston was ready to apply to Y Combinator, a highly regarded seed accelerator founded by Paul Graham, a well-known essayist, venture capitalist, and programmer. Twice a year, entrepreneurs accepted into the three-month program were offered seed funding (between \$14,000 and \$20,000), mentoring, and introductions in exchange for an average of six percent of a start-up's equity. The program culminated with a "Demo Day" during which entrepreneurs presented their pitch to a large audience of elite investors.

After submitting his application to Y Combinator, Houston attempted to attract Graham's attention by posting a three-minute screencast of Dropbox on Hacker News, Graham's online forum for developers.<sup>6</sup> The tactic paid off. Houston received \$15,000 in funding from Y Combinator and a coveted position in its upcoming summer cycle located in Boston (see **Exhibit 2** for Dropbox's hypothetical capitalization table). The video also held the top spot "for days," provided valuable feedback from the target audience, and attracted the interest of Arash Ferdowsi, a fellow MIT computer science student, who soon after partnered with Houston as co-founder and chief technology officer.<sup>7</sup>

### *Seed Financing*

Houston left Bit9 in May 2007 to pursue development of Dropbox on a full-time basis. Together, Houston and Ferdowsi spent the next four months working toward a beta version of the product and refining their seven-minute pitch to investors for the upcoming "Demo Day." As Houston recalled:

Through Y Combinator we met another seed-stage investment firm, and we had been talking with them for a few weeks before Demo Day. At the time, it actually looked like we were pretty close to sketching out a deal. Then we did our presentation at Demo Day and Pejman [Nozad] came running up to Arash [Ferdowsi]—they had the whole Iranian connection—and Pejman started chatting and said he was interested in investing. We didn't really know who he was and it looked like our angel round was about to come together...but Pejman can be pretty persistent so he convinced us to come down to his rug shop in Palo Alto where he ended up introducing us to Sequoia.<sup>8</sup>

<sup>6</sup> Drew Houston, "Startup Lessons Learned—Customer Development Case Study: Dropbox" (speech, San Francisco, April 23, 2010), Startup Lessons Learned, <http://www.slideshare.net/gueste94e4c/dropbox-startup-lessons-learned-3836587> (June 12, 2014).

<sup>7</sup> Eric Schonfeld, interview, *Founder Stories—Drew Houston: "Dropbox Users Save A Billion Files Every Three Days,"* TechCrunch, October 30, 2011, <http://techcrunch.com/2011/10/30/founder-stories-drew-houston-dropbox-users-save-a-billion-files-every-three-days/> (October 14, 2013).

<sup>8</sup> Interview with Drew Houston, September 17, 2013. Subsequent quotations are from the author's interviews unless otherwise noted.