Early Stage Financing Workshop

Seed and Venture Capital Financing Terms

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Early Stage Financing Workshop

1) Seed Investing Overview
2) VC Financing Overview
3) Term Sheet Valuation Issues
4) Preferred Stock Privileges
5) Investor Protections and Rights
6) Stock Purchase Terms
7) Conclusion

Preparing Your Company For Investment

- Look “conventional”
- Complete founders stock purchases
- Founders should have vesting but with acceleration provisions
- Avoid previous employer and other IP issues

Early Stage Financings (Types)

- Seed Financing
  - Friends, Family, Angels
  - Quick, Simple, Cheap
  - Type of Security – what the investor requires
- Venture Capital
- Corporate Partner
  - Valuation
  - “Strings attached”
- Debt Financing

Seed Financings: Use of Common Stock

- Pricing of common stock must be same for all sales at or about the same time. Cannot grant options to employees for $0.01 and sell shares of common stock to seed investors for $1.00 at the same time
- Selling Common Stock is not generally used because of the dilutive effect and impact on stock options
  - Consider number of shares at $0.01 per share needed to be sold to raise even $100!
- Objective is to keep the common stock price low as long as possible to motivate employees and other service providers with stock options

Seed Financings: Use of Preferred Stock

- Requires a pre-money valuation for the company. Investors will buy a percentage of the company
- Series A round can be complicated and expensive even if raising a small amount of money. Cost may be disproportionate to amount raised
- Defer a preferred stock financing if possible

Seed Financings: Use of Convertible Notes

- Issue convertible notes for “next financing” preferred stock
- Defers valuation decision and keeps the financing simple and low cost
- Discount on conversion rate (or warrants) is often used as a “sweetener” for the investors to take the risk

Venture Financing Overview

Preferred Stock Model

- Venture Capitalist Model
  - Cheap Common Stock (for Founders and Employees)
  - Expensive Preferred Stock (for Investors)
  - Investors Get Additional Rights to Hedge Operating and Financial Risks

- Privileges of Preferred Stock
  - Liquidation and Dividend Preferences
  - Voting Rights
  - Conversion Rights/Anti-dilution Protection
  - Redemption
  - Registration Rights
  - Information Rights
  - Participation Rights

Term Sheet Valuation Issues

- Context
- Methodology for Valuation (Pre-Financing)
  - Discounted Cash Flow
  - Multiple of Revenue/Sales
  - Multiple of Earnings
  - Real World – Private Company Factors
    - Customers
    - Revenues / Earnings
    - Product Development
    - Management
- How Much to Raise?
- How is Per Share Price Calculated?

Term Sheet Valuation Issues

Definitions

“Outstanding Securities” = Issued Common and Preferred Stock, options, warrants and convertible notes, and any other rights to equity that have been granted and paid for

“Option Pool” = Options that have been reserved for issuance but have not yet been granted

“Fully-Diluted Shares” (FDS) = Outstanding Securities plus Option Pool

“Pre-Money Valuation” = Set by Investor-Founder negotiation

“Per Share Price” = Pre-Money Valuation divided by FDS

“Post-Money Valuation” = Pre-Money Valuation plus New Money raised

Term Sheet Valuation Issues

Valuation Example

Founders – 5,000,000 shares at $0.01 = $50,000 valuation

Option Pool Required = 2,500,000 shares

Pre-Money Valuation = $3,000,000

FDS Pre-Series A = 7,500,000 shares

Per Share Price = $3,000,000/7,500,000 shares = $0.40 Series A Investment = $4,000,000

Series A Investment = $4,000,000

Series A Stock Issued = $4,000,000/$0.40 = 10,000,000 shares

FDS Post-Series A = 17,500,000 shares

Founders 28.58%, Option Pool 14.28%, Investors 57.14%

Post-Money Valuation = $7,000,000

Preferred Stock Privileges

- Liquidation Rights
- Conversion Rights
- Pay to Play Provisions
- Redemption Rights
- Dividends
- Protective Provisions

Preferred Stock Privileges

Liquidation Rights

- Preference (Investors get "off the top")
  - Available for merger / acquisition / sale of assets (not just liquidation)
  - Return of initial investment BEFORE common holders get paid
- Preferences Senior or Pari Passu with Other Series
- Multiple Preference
- Participation with Common (After Preference)
  - None: Investors DO NOT share with Common
  - Full Participation: Investors share PRO RATA with Common (as-if converted)
  - Capped Participation: Investors share Pro Rata with Common UNTIL (3x) return received
- Investors can convert to common

Participating Preferred Example

Assume $3M preferred investment for 60% of Company

Sale of Co. @	Pref. 1X	Common (40%)	Pref. 2X	Common
$3M	$3M	0	$3M	0
$6M	$4.8M	$1.2M	$6M	0
$10M	$7.2M	$2.8M	$8.4M	$1.6M
$15M*	$10.2M	$4.8M	$11.4M	$3.6M
$25M	$16.2M	$8.8M	$17.4M	$7.6M

* If 3X cap., Preferred max. out here

Preferred Stock Privileges

Conversion Rights

- Optional Conversion
  - Holders can convert to Common at any time
  - Lose all rights of Preferred Stock
- Automatic Conversion – must convert to Common if:
  - "Approved" IPO ($10-20M)
  - Majority (or 2/3) elect to convert (written)
- Conversion Ratio (Initially 1:1)
  - Event-Based changes
    - Stock splits, stock dividends, reverse stock splits
    - Retain same percentage ownership
  - Price Based changes (Dilutive Financing)
    - Anti-dilution Protections
    - Pay to Play

Preferred Stock Privileges

Anti-dilution Protection

- Weighted Average
  - Mechanics
    - Weights the difference in price (prior round and current) by proportion of shares (pre-financing and post-financing)
    - The fewer the “new dilutive” shares sold (relative to number in prior rounds) the less the reduction in conversion price
  - Narrow Based – include only Preferred shares outstanding in count (or Preferred and Common)
  - Broad Based – includes Preferred/Common outstanding and granted options / warrants (reduces effect of proportion)

Preferred Stock Privileges

Anti-dilution Protection

- Ratchet – reduce conversion price to new sale price
  - Full Ratchet – very harsh
    - Can cause great dilution for relatively few shares sold at lower price
  - Capped or Limited
    - Limit duration of ratchet, or extent
    - Ratchet is removed upon completion of performance targets
    - Ratchet is removed upon subsequent non-dilutive round

Preferred Stock Privileges

Anti-dilution Protection

- Carve-outs from Anti-dilution
  - Options grants to employees, consultants (any vs. only for authorized Pool)
  - Warrants to lenders, equipment liens
    - Any vs. limited amount
    - Majority vs. unanimous board approval
  - Warrants to service providers, suppliers, strategic partners (any/limited, BOD approval)
  - Shares issued in mergers / acquisition
  - Exercises or conversions of current stock or grants

Preferred Stock Privileges

Pay to Play

- Dilutive Financing ("down round") →
- Investor must purchase his pro-rata share
- Otherwise:
  - Investor loses all anti-dilution protection → convert investor's Preferred Shares to Shadow Preferred (without anti-dilution)
  - Investor loses ALL Preferred Stock privileges → convert investor's Preferred Shares to Common Stock
- Avoid "free riding" by non-paying investors

Preferred Stock Privileges

Redemption Rights

- Optional (Company Option: “Call”)
  - Company can repurchase stock if investors won’t convert to Common (after x years)
- Mandatory
  - Investor can force Company to repurchase shares
    - After [5-7] years – in installments over [3] years
    - Get liquidity if no public market
    - But, Company must have funds legally available
  - If not paid when due
    - Investors may take over control of Board
    - Resign / Replace board seats held by Common

Preferred Stock Privileges

Redemption Rights

- Redemption amount typically includes accrued, unpaid dividends → Redemption
- Redemption price
  - Original purchase price
  - Premium return (FMV)

Preferred Stock Privileges

Dividends

- Preferred has Priority
  - Preferred paid before common (as-converted)
  - Preferred may participate with Common
- Discretionary vs. Mandatory
  - Discretionary: no obligation to pay ever
    - "when, as and if declared by the Board"
  - Mandatory: must pay if legally available funds exist
- Non-cumulative vs. Cumulative
  - Non-cumulative: disappears if not declared (not due)
  - Cumulative: unpaid dividends accrue (still due)
    - Cumulate: annually, bi-annually, quarterly, or monthly

Preferred Stock Privileges

Dividends

- Watch out for Mandatory, Cumulative Dividends
  - Dividend may be payable in cash, or in additional preferred shares
  - Accrued dividend may be added to liquidation preference, if not paid when due
  - Compounds effect of participating liquidation preference

Preferred Stock Privileges

Protective Provisions

- Purpose: Requires the company to seek investor approval before taking certain actions
- Series v. Class
  - Class – need approval of [majority / some %] of all holders of Preferred Stock (all series voting together)
  - Series – need approval of [majority / some %] of all holders of an individual Series
    - May need separate approvals from other Series
    - Terminate if Series holds less than minimum % of original purchase (5-20%)

Preferred Stock Privileges

Protective Provisions

- Typical Preferred Stock approvals:
  - Amend Articles / Certificate (or Bylaws)
    - Alter / change rights, preferences of Series A
    - (materially and) adversely affect Series A
  - Reclassify outstanding securities into series senior or parity with Series A
  - Authorize new series – senior or parity to Series A
  - Increase / decrease authorized shares Preferred Stock
  - Merger / acquisition, sale of substantially all assets
  - Liquidation / dissolution
  - Declare or pay dividend
  - Change authorized number of Board Directors

Key Control Terms

- Founder / Employee Vesting
- Board Representation
- Preferred Protective Provisions

Control Terms

Vesting

- Required by investors to properly motivate the Employees and Founder(s) and protect Investor's Investment.
- Rank & File Employees
  - 4-year vesting: one year cliff and monthly thereafter
- Founder
  - X% fully vested upon Closing, a cliff period and monthly thereafter for total of 4 years
  - Change of Control & Termination without Cause/Constructive Termination

Control Terms

Board Representation

- Representatives
  - Company representative (CEO)
  - Founder (if not Company representative)
  - Preferred Stock Representative (Investors)
  - Independent Directors (industry specialist – appointed by all outstanding stock or other board members) – key issue
- Common Series A Board Makeup
  - Founder, CEO, Series A Rep (3-person Board)
- Non-Voting Board Observers

Investor Protections and Rights

- Rights of First Refusal and Co-Sale Rights
- Information Rights
- Registration Rights

Investor Protection and Rights

Rights of First Refusal (ROFR)

- New Issuances by Company
  - Investor right to purchase shares in new round
  - Up to pro-rata share of Company
  - Carve-outs for certain sales/transfers
  - Terminate: IPO, acquisition, sale of assets
- Sales by Founders
  - Investor right to purchase Founder’s shares (take deal offered by outside buyer to Founder)
  - Keep stock “in the family”
  - Carveouts: Gifts to immediate Family
  - Exclusions: minimal sales allowed (5-10%)
- Rare: Cross-rights over other investors

Investor Protection and Rights

Drag-Along and Tag-Along

- Drag-Along – Forced Sale Provision
  - Offer to shareholders by outside party to purchase all shares
  - If high % of shareholders accept, force remaining "holdouts" to sell
  - % required to trigger (high – e.g., 75%)
- Tag-Along (Co-Sale)
  - Founder wants to sell shares and has a buyer
  - Investors have right to sell their shares (pro-rata) to Founder's buyer (instead of Founder)
  - Exclusions: minimal sales allowed (5-10%)
- Termination
  - IPO, acquisition, sale of assets, dissolution
  - Investor owns less than (5-15%) of purchased shares
  - (3-5) years after close financing
  - Majority Investors agree to terminate

Investor Protection and Rights

Information Rights and Covenants

- Information Rights – Financials
  - What and When?
    - Annual Statements – [120 days]
    - Quarterly financials – [45 days]
    - Monthly statements – [45 days (possibly)]
    - Budgets/Plan – [30 days after close fiscal year]
  - Audited (costly, annual statements only)
  - Who gets rights (minimum holdings/transfer) – 25%
  - Termination – at IPO, acquisition, sale of assets
- Market Standoff Restriction

Investor Protection and Rights

Registration Rights

- Demand Registration
  - Require Company to Register Investor Shares
  - IPO or Subsequent Offering (S-1 “long form”)
- S-3 Registration
  - “Short-form” Registration
  - Available after 1 year (if required filings made)
  - Much simpler, quicker, and cheaper

Investor Protection and Rights

Registration Rights

- Issues for IPO Demand
  - Demand IPO after how many years? (3-5)
  - Minimum Offering for IPO? ($5-10M)
- Issues for all Demands
  - Number Demands allowed
    - S-1: 1-2
    - S-3: unlimited (but only 1-2 per year)
    - Minimum Offering for S-3 demand ($1-3M)
  - Minimum % Investor shares to require Demand
    - 25-40% Investor Shares
  - Can Company Delay Registration?
    - 90-120 days / strategic or market reasons

Investor Protection and Rights

Registration Rights

- Piggyback Registration
  - Require Company to include Investor's Shares in Company's Subsequent Offerings (not IPO)
- Issues for Piggyback Registrations
  - Underwriter Cutbacks (up to 20-25%)
  - No piggyback on demand, S-3, benefit plans, reorganizations

Investor Protection and Rights

Registration Rights

- Issues for ALL Registrations
  - Who Pays for Registration?
    - Company pays (except underwriting commissions)
    - Including costs for counsel for selling shareholders
  - Minimum holding by investor to have rights
  - Minimum amount for rights to transfer
  - Termination of rights
    - Some years after IPO (e.g., 7 years)
    - To the extent shares that can be sold under SEC Rule 144

Conclusion

- Current financing environment continues to improve, but mixed signals persist
  - Valuations continue to improve (though VC investment decreased by 10% - 15% in Q4’05 vs. Q5’04)
  - To build interest
    - Be able to demonstrate customers/revenue product achievement
    - Be able to show where the company will be when the funding is spent
- Negotiate the important stuff, skip the small stuff
  - Valuation/Dilution, but don’t let it kill the deal
  - Liquidation Preferences
  - Protective Provisions
  - Board Control
- Materials
  - Sample Venture Capital Term Sheet
  - Q1 2005 Quarterly Venture Capital Terms Survey
  - Q1 2005 PWC Money Tree

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