

Angel Financing: Selecting the Investor and Negotiating the Term Sheet – The Entrepreneur’s Perspective

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Today's Angel Market - Signs of Steady Growth

- The market has shown steady growth in 2006, with total investments of \$25.6 billion, and increase of 10.8% over 2005.⁽¹⁾
- 51,000 entrepreneurial ventures received angel funding in 2006, a 3% increase from 2005.⁽¹⁾
- 234,000 individuals were active angel investors in 2006.⁽¹⁾
- Average deal size in 2006 increased by 7.5% over 2005.⁽¹⁾
- Number of angel investor groups continue to increase, up nearly 60% from 2002-2005, from 150 groups to 250 groups.⁽²⁾

⁽¹⁾ The Angel Investor Market in 2006: The Angel Market Continues Steady Growth, Center for Venture Research (CVR) at the University of New Hampshire

⁽²⁾ The Angel Capital Education Foundation, a program of the Ewing Marion Kauffman Foundation.

Today's Angel Market – Stages of Investment

- Angels continue to be the largest source of seed and start-up capital.⁽¹⁾
- Investments by Stage in 2006⁽¹⁾
 - Seed and Start-up – 46%
 - Post-seed/start-up – 40%
- Market conditions and the capital gap in the post seed investing stage are requiring angels to engage in more later stage investments.⁽¹⁾
- Resulting in fewer dollars available for seed investments and increasing the capital gap for seed and start-up capital.

⁽¹⁾ The Angel Investor Market in 2006: The Angel Market Continues Steady Growth, Center for Venture Research (CVR) at the University of New Hampshire

Today's Angel Market – What do Angels Look for?

- Angels invest their own money in early stages of private, high-growth ventures.⁽⁴⁾
- Reasons for funding rapidly growing firms:⁽⁴⁾
 - economic growth
 - use of their expertise
 - personal enjoyment
- Tend to invest close to where they live; often within a 3-4 hour (30 minute?) drive from their office.⁽⁴⁾

⁽³⁾ William H. (Bill) Payne, Senior Program Consultant, Ewing Marion Kauffman Foundation.

⁽⁴⁾ "Finding Business 'Idols': A New Model to Accelerate Start-Ups," Kauffman Foundation.

Today's Angel Market – What do Angels Look for?

- Deals are found through their networks and are typically investments where they can leverage their industry or operations expertise.⁽⁴⁾
- Typical Investment size = \$25K-100K/ each angel.⁽³⁾
 - \$250,000 - \$1.0 million total investment per round
 - Above \$500,000 extremely hard to attain
- Company valuations run from \$1M-\$3M.⁽³⁾

⁽³⁾ William H. (Bill) Payne, Senior Program Consultant, Ewing Marion Kauffman Foundation.

⁽⁴⁾ "Finding Business 'Idols': A New Model to Accelerate Start-Ups," Kauffman Foundation.

Angel Financing Overview

- What to Expect: Common Practice
- Company Formation Issues
- Selecting the Right Investor
- Series A Term Sheet
- Common Pitfalls
- Q & A

What do Angels Expect?

- Angels purchase from 20-40% of a company's equity.(3)
- Angels seek a return of 20x-30x over five years.(3)
- More flexible investment structures
 - Bridge Debt
 - Common Stock
 - Preferred Stock
 - Want “discount” and/or protections if subsequent round possible/probable, especially if VCs to be sought

(3) William H. (Bill) Payne, Senior Program Consultant, Ewing Marion Kauffman Foundation.

Structuring Company Ownership

- Types of equity interests
 - Common stock versus preferred stock
- Allocating ownership among the founders
- Contribution of IP and past services vs. future services to be rendered
- Valuing stock and options issued to founders and employees

Selecting the Right Investor

- Establishing long-term relationship
- Maintain flexibility for future rounds
- Types of Investors / Financing
 - VCs (institutional investors)
 - Strategics (companies)
 - Angels / Angel networks
 - Friends & Family ([hopefully] high net worth individuals)
 - Bootstrapping

Selecting the Right Investor

- Referrals by Professionals
 - Use Caution with Finders / Brokers, esp. in early rounds
- Your Due Diligence: The Investor
 - References from Portfolio Founders
 - Internet and Publications
 - Attorneys and Accountants
 - Fund size (“dry powder”) and track record
 - Industry / Strategic Expertise
- Things to Consider
 - You will have to live with (and perhaps expand) these terms for later rounds
 - Create incentive for future investment (pay-to-play)
 - Avoid investment by strategics in early rounds to maintain more flexibility

Seed and Angel Financing Alternatives

BRIEF SUMMARY OF ANGEL/SEED FINANCING ALTERNATIVES

1. Bootstrap (E.g., internally fund through revenues, government grants, consulting services, funded development contracts, etc.)

Pros: Minimizes dilution / distraction from financing

Cons:

- Pursuit of near-term revenue may divert attention from pursuit of core, strategic business, reducing long-term value prospects
- May hinder rapid development which may permit other firms to gain competitive advantage

Seed and Angel Financing Alternatives

BRIEF SUMMARY OF ANGEL/SEED FINANCING ALTERNATIVES (cont.)

2. **Straight Loan** (no coverage, no warrants)

Pros: Very simple, no valuation set

Cons:

- Unrealistic to request
- Unlikely to be acceptable to investors who want equity upside for their risk

Seed and Angel Financing Alternatives

BRIEF SUMMARY OF ANGEL/SEED FINANCING ALTERNATIVES (cont.)

3. Bridge Loan #1 (convertible at next round price; no discount, no warrant coverage)

Pros:

- Simple and standard forms
- No valuation set
- Minimizes dilution from option 4 or 5
- Avoids usury issues

Cons: Early investors likely will require more "upside" to mitigate their risk

Seed and Angel Financing Alternatives

BRIEF SUMMARY OF ANGEL/SEED FINANCING ALTERNATIVES (cont.)

4. **Bridge Loan #2** (convertible at discount to next round price)

Pros: Still standard forms, no valuation set

Cons: Raises “usury” issues

Seed and Angel Financing Alternatives

BRIEF SUMMARY OF ANGEL/SEED FINANCING ALTERNATIVES (cont.)

5. Bridge Loan #3 (convertible at next round price with warrant coverage - % and pricing TBD)

Pros:

- Still standard forms (but more paperwork)
- No valuation set
- If loan (all loans that close concurrently can be aggregated) greater than \$250,000, warrants excluded from usury calculation
- Avoids valuation

Cons: Negotiation of warrant coverage (percentage, price, underlying stock)

Seed and Angel Financing Alternatives

BRIEF SUMMARY OF ANGEL/SEED FINANCING ALTERNATIVES (cont.)

6. Common Stock

Pros: Simple (which generally translates into lower transactional costs)

Cons:

- Must establish an implied valuation; "taints" option pool -- i.e., sets a fair market value of common stock which has implications for options
- Will need to discuss what stockholder agreements look like
- No "downside" protection for investor

Seed and Angel Financing Alternatives

BRIEF SUMMARY OF ANGEL/SEED FINANCING ALTERNATIVES (cont.)

7. “Seed” Preferred Stock (very simple “Seed” Preferred Stock with little or no negotiation with investors)

Pros:

- Fairly simple (relatively low transactional costs)
- Allows you to "discount" options due to preferred liquidation preferences
- Modest investor protection

Cons:

- Requires that an implied valuation must be established, which you generally will want to avoid at the early stage
- The terms of the preferred stock may invite further negotiation

Seed and Angel Financing Alternatives

BRIEF SUMMARY OF ANGEL/SEED FINANCING ALTERNATIVES (cont.)

8. Standard “Venture” Preferred Stock (a more complete version of the Preferred Stock which would generally be expected in a venture capital transaction)

Pros:

- Can use as a template for the next round (puts entire framework in place)
- May be more palatable to experienced investors
- Allows option discounting and more investor protection

Cons:

- Must establish valuation (a common theme)
- Higher transaction expenses
- Invites more negotiation
- Generally only viable with larger investment (\$1-2 million +)

Term Sheet Terminology

- Common vs. Preferred Stock
- Liquidation Preference
 - Participating; Full vs. Capped
- Convertible Securities
 - Conversion Rights; Auto-Convert
- Antidilution Provisions
 - Weighted Average vs. Ratchet
- Redemption
- Protective Provisions; Board Seats
 - Voting Rights / Protective Divisions
- See Appendix of Key Terms

Common Start-up Pitfalls

- Inadequate early stage structuring and poor recordkeeping (especially equity)
- Failure to protect intellectual property assets
- Investment by too many (or the wrong) friends, family and angel investors (administrative and management burden)
- Previous violations of state securities laws
- Unrealistic expectations of inexperienced early investors
- Previous unsupportable valuations
- Unique or non-standard terms in earlier financing agreements requiring significant revisions
- Too many board members and advisors (“hangers on”)
- Brokers and finders

Key Terms

- **Pre-Money Valuation** – the valuation of the business before any investment by an outside party
 - Possible to avoid / defer through the use of convertible bridge loans
- **Post-Money Valuation** – the value of the business after the completion of an investment by an outside party
- **Common Stock** – the most basic form of stock representing the residual value of the company; held by founders and employees
- **Founder's Stock** – these are the shares that the founders of company purchase or typically receive at the creation of the company, usually for very low value (e.g. \$0.001 per share)
- **“Reverse” Vesting** – a mechanism to provide for time-based vesting, *often imposed by an investor after the fact*, to permit a company to repurchase a decreasing percentage of shares of founder's stock over time based on a vesting schedule

Key Terms

- **Option Pool** – a portion of the company’s outstanding stock set aside for use as incentive compensation for present and future employees. Allocated and unallocated amounts and required increases included in pre-money valuation
- **Preferred Stock** – a form of stock usually held by investors with certain rights and preferences superior to those of common stock, including liquidation preference, redemption and anti-dilution rights, and governance, voting and board rights and restrictions
- **Liquidation Preference** – the right of preferred stock holders to receive the value of their investment before any other liquidation distributions are made to other equity holders. Usually includes “participation” provision for the preferred stock to continue to share proceeds with the common
- **Antidilution Rights** – the right of preferred stock holders to maintain its fractional ownership percentage if shares are later issued at a lower valuation

Preferred Stock Liquidation Scenarios

Example One: Participating Preferred - \$10 million sale price

Preferred Stockholders invested \$5 million for 50% of the company.

	<u>Preferred Stock</u>	<u>Common Stock</u>
Preference	\$5,000,000	\$ -
Participation	<u>\$2,500,000</u>	<u>\$2,500,000</u>
Total	<u>\$7,500,000</u>	<u>\$2,500,000</u>

*Note: All liquidation scenarios ignore effect of cumulative dividends. Accrual dividends would be added to preference portion.

Preferred Stock Liquidation Scenarios

Example Two: Participating Preferred with 3x cap- \$25 million sale price

Preferred Stockholders invested \$5 million for 50% of the company.

	Preferred Stock	Common Stock
Preference	\$5,000,000	\$ -
Participation	<u>\$10,000,000</u>	<u>\$10,000,000</u>
Total	<u>\$15,000,000</u>	<u>\$10,000,000</u>

*Note that the cap was reached but Preferred will not convert

Preferred Stock Liquidation Scenarios

Example Three: Participating Preferred with 3x cap vs. fully participating preferred - \$50 million sale price

Preferred Stockholders invested \$5 million for 50% of the company.

	<i>3x Capped Preferred</i>		<i>Fully Participating Preferred</i>	
	Preferred Stock	Common Stock	Preferred Stock	Common Stock
Preference	N/A*	\$ -	\$5.0 million	\$ -
Participation	<u>\$25,000,000</u>	<u>\$25,000,000</u>	<u>\$22,500,000</u>	<u>\$22,500,000</u>
Total	<u>\$25,000,000</u>	<u>\$25,000,000</u>	<u>\$27,500,000</u>	<u>\$22,500,000</u>

*Note: 3x Cap (\$15 million) would result in lower proceeds, so Preferred converts to Common

Final Thoughts

- Confirm you are an angel investment candidate and can work with investors
- Obtain competent and experienced advisors
- Keep it simple
- Find the right investor(s) (read: “partner”)
- Set investors’ (and your) expectations in advance
- Don’t be rushed – strongly consider bootstrapping (you may not have an alternative)

Thank you!

Open discussion / Q&A

A Focus on Emerging Growth

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Matt Lyons is an Austin partner with Andrews Kurth, where he specializes in representing private and public emerging growth companies and entrepreneurial interests. He advises on all aspects of forming new businesses, raising capital, M&A, and securities laws & regulations. He also regularly counsels companies and their boards on corporate governance and executive compensation. Matt represents and maintains relationships with a number of prominent venture capital, private equity and investment banking firms.

Matt has consistently been named as one of the leading lawyers in Texas for the area of Technology: Corporate and Commercial in the Chambers USA Rankings. He also has been Martindale-Hubbell "Peer Review Rated" for Ethical Standards and Legal Ability. Matt has been named a "Texas Rising Star" in the area of Securities and Corporate Finance by Texas Super Lawyers and Texas Monthly Magazine. Matt received his undergraduate and law degrees from the University of Texas at Austin.

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