

Venture Financing: Selecting the Investor and Negotiating the Series A Term Sheet – The Entrepreneur’s Perspective



Matthew Lyons
Andrews Kurth LLP
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Overview

- The Entrepreneur's Perspective
- Selecting the Right Investor
- The Investor's Perspective
- The Term Sheet
- Appendices

Entrepreneur's Perspective

- Are you a Venture Capital candidate?
- Understand the Investors' motivations, economics
 - Is venture capital right for you?
- Understand what you care about (control, valuation, etc.)
- Have multiple options, if possible
- Think creatively – there's more than one solution to a problem
 - Bootstrapping
- Avoid value reducing / limiting issues
- See Appendix - “Common Start Up Pitfalls”

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

The Investor's Perspective

- Some improvement, but liquidity pathways and timeframes remain uncertain
- Focus is on solid, sustainable, capital efficient business models with **experienced management**
 - *Businesses* are fundable, *ideas* are not
- More variety in deal terms
- Less flexibility on valuations

The Investor's Perspective

- Syndication is back
- Still hard to get new money to pull the trigger
 - Expect it to take **at least** 6 to 12 (painful) months
 - Expect to talk to **dozens** of VCs
- Much more due diligence – business and legal, including founders, mgmt.
- Bridge Rounds harder to secure from VCs
 - Why should they pay to negotiate against themselves?
 - Staged and milestone-based
 - % warrant coverage

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

Negotiating the Term Sheet

- The Trade-off: often a Hobson's choice of Valuation vs. Terms
- Current Valuation Perspectives
 - Be realistic about the timing and prospects for, and the possible value of, a liquidity event
 - Today's valuation sets expectations for the next round of financing, so think through the implications, both positive and negative, of a current valuation offer
 - **The Series A terms form the basis for all future rounds**

Trends in Venture Terms

- Valuation
 - The total enterprise value for purposes of setting the stock price – the “black art” of the VCs
 - Reduced exit valuations and delayed exits can affect early stage values
 - Be careful of disguised valuation reductions
 - Large Pre-Money Option Pool
 - Milestone-based anti-dilution triggers
 - Milestone-based Closings
 - Disproportionate liquidation preferences (3x, no cap – “double dip,” etc.)
 - Cumulative Dividends
 - Warrants

Trends in Venture Terms

- Liquidation Preferences
 - Right to receive proceeds upon liquidation (including sale of company) before any distribution to common shareholders
 - Seniority over junior preferred stock and common
 - Super liquidation preference (e.g., 3x preference off the top) NOT common at early stage
 - Fully participating with no cap (i.e., full participation right) becoming more prevalent way to increase potential returns on winners
 - Try to cap participation (e.g., 3x the original purchase price)
 - Accrued dividends
 - See appendices for examples

Trends in Venture Terms

- Dividends
 - Cumulative vs. non-cumulative
 - Payable upon conversion (PIK dividends)
 - Greater of cash, FMV of common stock or conversion price

Trends in Venture Terms

- Antidilution (“Price”) Protection
 - Provides for more common to be issued on conversion of the preferred in the event of bad events (down round, missed milestone, etc.)
 - Types:
 - Broad-based vs. Narrow-based
 - Broad-based still the most common
 - Full ratchet
 - Full ratchet for a period of time (or until milestone met) and then broad-based
 - Exclusions are key (option pool, strategic investments, charitable, etc.)

Trends in Venture Terms

- Redemption
 - Right to have Company repurchase the shares after a period of time (usually 5-7 years)
 - *Rarely* used, but do have purpose: focusing company on liquidity event
 - Terms:
 - Sometimes includes accrued dividends (like debt)
 - Sometimes greater of fair market value or cost
 - Voting or board changes or additional interest for failure to redeem
 - Redemption required when reps, covenants breached
 - Time period (5-7 years vs. 3 years)
 - Shorter time periods for less certain deals
 - Structured pay-out (e.g., 3 years vs. one-time)

Trends in Venture Terms

- Voting Rights / Veto Provisions
 - Board approval (including preferred directors)
 - Restrictions on changes in Series A terms, or authorization / issuance of senior securities
 - Sale of the company
 - Can include many operational covenants or restrictions, including:
 - Hiring certain executives
 - Changing line of business
 - Increasing the option pool
 - Increasing salaries
 - Incurrence of indebtedness over certain amount
 - Capital expenditures over certain amount
 - Detailed use of proceeds, budget approval

Trends in Venture Terms

- Board Composition
 - Greater VC control and participation
 - Greater control over “swing” vote or independent director
 - Broader Indemnification and insurance obligations (especially in down rounds)

Trends in Venture Terms

- Conditions to Closing
 - Milestone-based funding
 - CEO Search
 - D&O Insurance
 - More Restrictive Employee Stock Restriction Agreements (“reverse vesting”)
 - Non-competes
 - Minimum investment amount
 - Syndicate, Additional Investor

Trends in Venture Terms

- “Pay to Play” Provisions
 - Require existing holders to participate in new rounds of financing or be subject to forced conversion into common or flip into junior preferred with less rights (voting, anti-dilution protection, etc.)
 - Designed to reward participation in future rounds and penalize non-participation
 - Sometimes triggered only by non-participation in down rounds

Final Thoughts

- Confirm you are a venture capital candidate
- Obtain competent and experienced advisors
- Don't be rushed – **consider bootstrapping** (you may not have an alternative)
- Find the right investor (read: “partner”)
- Set investors’ (and your) expectations in advance
- Focus on the Series A terms as they will follow the Company

Q & A

Appendices

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

Structuring the Company: Capitalization Summary

	<u>Formation</u>		<u>Series A Preferred (\$5 Million Pre-Money \$5 Million Invested)</u>		<u>Series B Preferred (\$15 Million Pre-Money \$7.5 Million Invested)</u>		<u>Series C Preferred (\$50 Million Pre-Money \$10 Million Invested)</u>	
	<u>Shares</u>	<u>%</u>	<u>Shares</u>	<u>%</u>	<u>Shares</u>	<u>%</u>	<u>Shares</u>	<u>%</u>
Common (Founders)	2,500,000	100%	2,500,000	25%	2,500,000	14%	2,500,000	12%
Option Pool	---	---	2,500,000	25%	4,464,285	25%	5,000,000	20%
Series A Preferred	---	---	5,000,000	50%	5,000,000	28%	5,000,000	23%
Series B Preferred	---	---	---	---	5,892,857	33%	5,892,857	28%
Series C Preferred	---	---	---	---	---	---	3,613,945	17%
Total	2,500,000	100%	10,000,000	100%	17,857,142	100%	21,258,503	100%

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.

	Preferred Stock	Common Stock
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

A Focus on Emerging Growth

ANDREWS KURTH LLP Emerging Growth and Technology Practice

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MATT LYONS

phone: (512) 320-9284
fax: (512) 320-9292
email: mlyons@akllp.com

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.