



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



**Matthew Lyons
Andrews Kurth LLP**

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111 Congress, Suite 1700 • Austin, Texas 78701 • 512.320.9200 • 512.320.9292 Fax

Austin • Beijing • Dallas • Houston • London • New York • Washington, DC • The Woodlands



Today's Start-Up Market Highest Level of Investment Since 2001

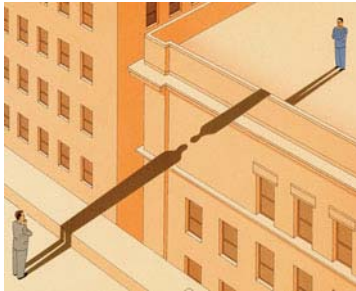
- According to the NVCA, seed and early-stage companies received more financing and dollars in 2006, however the largest gains in 2006 were once again seen in Expansion Stage deals.
- First-time financings reached their highest level since 2001.
- Aggregate VC investment for 2006 totaled \$25.5 billion (3,416 deals)⁽¹⁾ compared to \$21.68 billion (2,939 deals) in 2005, \$21.63 billion (2,966 deals) in 2004 and 19.58 billion (2,865 deals) in 2003.
- Startup/early stage funding increased to \$5.0 billion in 1,176 deals compared to \$4.4B in 1,018 deals in 2005 and \$4.4B in 1,038 deals 2004.
- Seed and Early Stage companies received \$5.0 billion going into 1,174 deals in 2006, compared to \$4.4 billion going into 1,018 deals in 2005. 34% of VC deals in 2006 were in Seed and Early-Stage companies.

⁽¹⁾ MoneyTree™ Survey Full-Year and 2006 Results by PriceWaterhouseCoopers and the National Venture Capital Association



Venture Financing Overview

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



What Do VCs Expect?

- The Four Ms:
 - Model
 - Market
 - Management
 - Momentum



What Do VCs Expect?

- Structure : C Corporation (DE or TX)
- Founders: Common Stock
 - Vesting/Acceleration Issues
 - 83(b) Election
- Employees: Option Pool; Standard Terms
- Investors: Preferred Stock



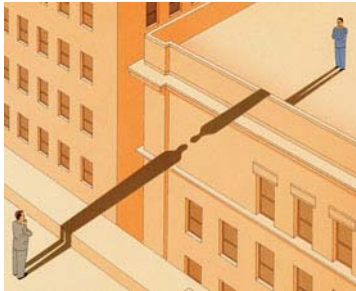
Selecting the Right Entity and Jurisdiction

- Venture capitalists prefer C corporations
 - Investor familiarity with centralized management structure and formalities
 - Some private equity funds are precluded from investing in pass through entities for tax reasons
 - Full range of exit strategies or liquidity options not available to other entity types
 - Lower organizational and ongoing administrative costs than an LLC or LP
- Venture capitalists prefer Delaware
 - Well-formed body of corporate law, including long-established principles in case law and ease of filing
 - Increased flexibility under Delaware law with respect to Board composition and corporate administration
 - National understanding of Delaware law among practitioners



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



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%	4,251,701	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%



Founders: Common Stock

- Vesting
 - 4 years
 - Buy back at cost upon termination of employment
 - 83b Election
 - Acceleration Issues
- Right of first refusal for sale to third parties



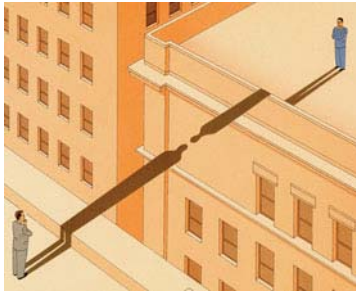
Employees: Stock Options

- Benefits of Incentive Stock Option Plans
- Structure
 - Vesting (4 years with 1 year cliff)
 - Early Excise of Options
 - Valuation Issues Under IRC §409A
- VCs want option pool included in “Pre-Money” Valuation
 - 10-30% of Post-Financing Equity
 - Should cover options to be issued in 12-24 months



Selecting the Right Investor

- Long-term Relationship
 - VCs vs. Strategics vs. Angels/Individuals vs. “Bootstrapping”
- Referrals by Professionals
 - Use Caution with Finders/Brokers
- Your Due Diligence: The Investor
 - References from Portfolio Founders
 - Internet and Publications
 - Attorneys and Accountants
 - Fund size (“dry powder”) and trade record
 - Industry / Strategic Expertise



Term Sheet Terminology

- Common vs. Preferred Stock
- Convertible Securities
 - Conversion Rights; Auto-Convert
- Antidilution Provisions
 - Weighted Average vs. Ratchet
- Liquidation Preference
 - Participation?; Full vs. Capped
- Redemption
- Protective Provisions; Board Seats



Negotiating the Term Sheet

- The Trade-off: 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



Common Pitfalls

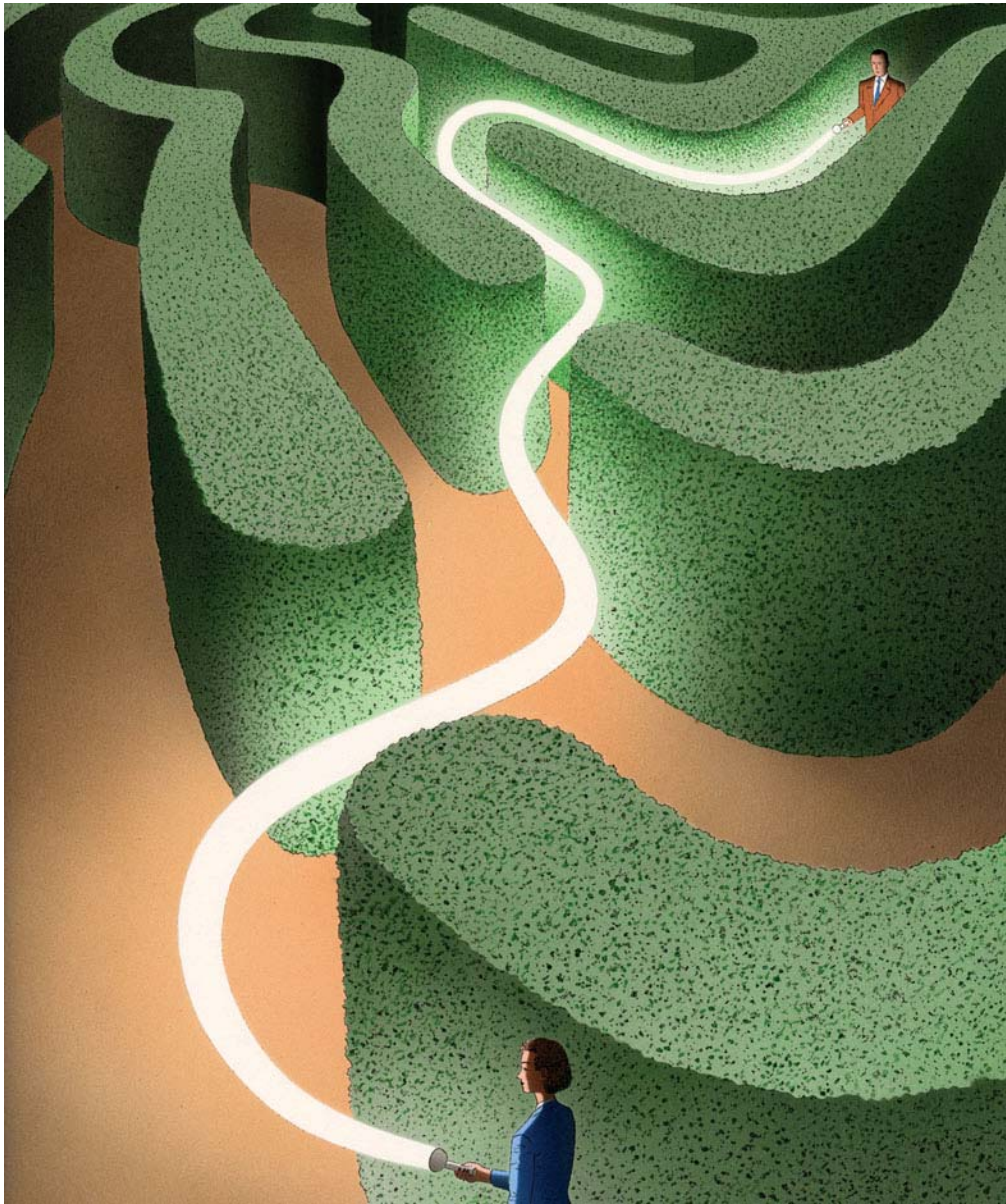
Do it right the first time...your deal will follow the Company until it goes public or gets acquired

- Inadequate Early Stage Structuring
- Failure to Protect IP
- Founder and Angel / Seed Funding Capitalization Issues
- How do VCs view Angel Rounds?
- Previous Valuations
- “Non Binding” Term Sheets
 - Subject to completion of syndicate
- Unique or Non-Standard Terms
 - Fees to Investors
- Brokers



Final Thoughts

- Confirm you are a venture capital candidate
- Obtain competent and experienced advisors
- Keep it simple
- Find the right investor (read: “partner”)
- Set investors’ (and your) expectations in advance
- Don’t be rushed -- **consider bootstrapping** (you may not have an alternative)



Q & A

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