



# Funding Alternatives in the Current Economic Environment

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## RISE 2010

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# Overview



- Current Financing Market
- Key Terms
- Bootstrapping
- Basic Deal Structures
- Government Funding
- Questions & Answers



# Current Financing Market

# Current Financing Market



- Institutional capital has been concentrating on existing investments instead of making new ones. Anecdotal evidence suggests angels have cut back as well. Many funds cannot raise more capital
- Valuations are down substantially, but seem to have leveled out
- IPO market was very poor the last 12 months, but new filings
- M&A has been down, but seems to have started a rebound in the last half of 2009
- Liquidity events are typically 6-8 years out; M&A is still the most common exit
  - This is making early stage capital harder to get
- Hard to get new money to pull the trigger
  - Typically takes at least 6 to 12 months
  - Expect to talk to dozens of VCs

# Current Financing Market



- Extensive due diligence on the business plan, market, founders and management
- Focus is on solid, sustainable, capital efficient business models with **experienced management**
  - *Businesses* are fundable, *ideas* are not
- Valuation Drivers: Developed product; paying customers; revenue; large addressable market; strong management team; proprietary technology/barriers to entry
- Choose competent and experienced advisors
  - Focused expertise provides efficiencies
  - Know trends in deal terms
  - Can make introductions to sources of capital and other experienced service providers
- Avoid creating due diligence/deal issues



# Venture Capital Model



## Capitalization Summary

|  | Series A Financing | Series B Financing | Series C Financing | IPO           |
|--|--------------------|--------------------|--------------------|---------------|
| Fully-Diluted Outstanding Value (pre-money)  | \$5,000,000        | \$20,000,000       | \$50,000,000       | \$150,000,000 |
| New Money                                    | \$5,000,000        | \$10,000,000       | \$25,000,000       | \$75,000,000  |
| Target Post-Money Option Pool                | 18.0000%           | 18.0000%           | 18.0000%           | 18.0000%      |
| Price Per Share                              | \$0.6400           | \$1.1395           | \$1.6907           | \$3.0103      |
| Fully-Diluted Outstanding Value (post-money) | \$10,000,000       | \$30,000,000       | \$75,000,000       | \$225,000,000 |

| Capitalization                    | Organization |         | Series A Financing |         | Series B Financing |         | Series C Financing |         | IPO        |         |
|-----------------------------------|--------------|---------|--------------------|---------|--------------------|---------|--------------------|---------|------------|---------|
|                                   | Shares       | Percent | Shares             | Percent | Shares             | Percent | Shares             | Percent | Shares     | Percent |
| Founder 1                         | 2,500,000    | 40.00%  | 2,500,000          | 16.00%  | 2,500,000          | 9.50%   | 2,500,000          | 5.64%   | 2,500,000  | 3.34%   |
| Founder 2                         | 2,500,000    | 40.00%  | 2,500,000          | 16.00%  | 2,500,000          | 9.50%   | 2,500,000          | 5.64%   | 2,500,000  | 3.34%   |
| Option Pool                       | 1,250,000    | 20.00%  | 1,250,000          | 8.00%   | 2,812,499          | 10.68%  | 4,738,869          | 10.68%  | 7,984,666  | 10.68%  |
| Option Pool Increase              |              |         | 1,562,499          | 10.00%  | 1,926,370          | 7.32%   | 3,245,797          | 7.32%   | 5,468,952  | 7.32%   |
| Series A Preferred Stock Investor |              |         | 7,812,499          | 50.00%  | 7,812,499          | 29.67%  | 7,812,499          | 17.61%  | 7,812,499  | 10.45%  |
| Series B Preferred Stock Investor |              |         |                    |         | 8,775,684          | 33.33%  | 8,775,684          | 19.78%  | 8,775,684  | 11.74%  |
| Series C Preferred Stock Investor |              |         |                    |         |                    |         | 14,786,424         | 33.33%  | 14,786,424 | 19.78%  |
| Public Investors                  |              |         |                    |         |                    |         |                    |         | 24,914,112 | 33.33%  |
| Total (fully diluted)             | 6,250,000    | 100.00% | 15,624,998         | 100.00% | 26,327,052         | 100.00% | 44,359,273         | 100.00% | 74,742,337 | 100.00% |

| Financing       | Money       | Shares    | Money        | Shares    | Money        | Shares     | Money        | Shares     |
|-----------------|-------------|-----------|--------------|-----------|--------------|------------|--------------|------------|
| Price per share | \$0.6400    |           | \$1.1395     |           | \$1.6907     |            | \$3.0103     |            |
| New Investment  | \$5,000,000 | 7,812,499 | \$10,000,000 | 8,775,684 | \$25,000,000 | 14,786,424 | \$75,000,000 | 24,914,112 |

| Option Pool Detail | Shares    | Percent  | Shares    | Percent  | Shares    | Percent  | Shares     | Percent  |
|--------------------|-----------|----------|-----------|----------|-----------|----------|------------|----------|
| Total Current      | 1,250,000 |          | 2,812,499 |          | 4,738,869 |          | 7,984,666  |          |
| Pool Increase      | 1,562,499 |          | 1,926,370 |          | 3,245,797 |          | 5,468,952  |          |
| New Total          | 2,812,499 | 18.0000% | 4,738,869 | 18.0000% | 7,984,666 | 18.0000% | 13,453,618 | 18.0000% |

# Key Terms



- **Pre-Money Valuation** – the value 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 of common stock that 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. Sometimes 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

# Key Terms



- **Preemptive Rights** – the right of investors to purchase their pro rata share of any future equity issuances
- **Registration Rights** – the right of investors to require the company to register their shares with the SEC for sale into public markets

# 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> |
|----------------------|------------------------|---------------------|
| <b>Preference</b>    | \$5,000,000            | \$ –                |
| <b>Participation</b> | <u>\$2,500,000</u>     | <u>\$2,500,000</u>  |
| <b>Total</b>         | <u>\$7,500,000</u>     | <u>\$2,500,000</u>  |

# 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.

|               | <u>Preferred Stock</u> | <u>Common Stock</u> |
|---------------|------------------------|---------------------|
| 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, as there is no difference

# 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

- Take on consulting jobs to provide cash flow to fund the main business
- Work nights and weekends on the “side project”
  - Be sure to only work on your own time using your own resources
- If web app, leverage Amazon S3, EC2, etc., open source software and outsourcing



# Basic Deal Structures

# Structures



- **Straight Loan** – very simple and no valuation needed, but no upside to investor; rarely used
- **Bridge Loan**
  - Type 1: Convertible at next round price & no warrant coverage. Less “upside” compared to the risk of angel investment
    - Favored by companies and VCs
  - Type 2: Convertible at next round price with X% warrant coverage.
    - Requires closing at least \$250,000 to avoid Texas state usury laws
    - Type 1 and 2 most common
  - Type 3: Convertible at discount to next round price **but** could create “usury” issues under Texas law

# Structures



- State usury laws prohibit high interest rates
  - Interest includes all other benefits payable (e.g. next round discount); warrants included on <\$250,000
  - Under Texas law, the penalty equals the greater of (1) 3x the difference between the amount charged and the legally permitted amount or (2) the lesser of \$2,000 or 20% of the principal

- **Common Stock** – simplest structure with minimal transaction costs but requires an implied valuation; rarely used
  - “taints” option price
  - Offers no investor protection
- **Preferred Stock**
  - “Seed” Preferred: simple liquidation preference and other terms to permit some “discounting” of options
  - Standard Preferred: standard “venture capital” formula preferred stock favored by more experienced investors but entails higher transaction costs
    - Use varies with size of investment

# Structures



- Customary Terms:
  - Common vs. Preferred Stock
  - Valuation
  - Dividends
  - Liquidation Preferences/Participating Preferences
  - Conversion Rights and Anti-Dilution Protection
  - Preemptive Rights
  - Redemption Rights
  - Protective Provisions
  - Board Structure
  - Registration Rights
  - Information Rights
  - Rights of First Refusal and Co-Sale



# Government Funding



- <https://www.fedconnect.net/Fedconnect/>
- ARRA (the “Stimulus Act”)
  - Grants, loan guarantees, etc.
  - Usually for projects that can scale up fairly quickly
  - Must pay prevailing union wages in an area
  - Opportunities issued pursuant to well defined Funding Opportunity Announcements (“FOAs”)
  - Can be very helpful for project development
- SBIRs
- Other research grants



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## QUESTIONS?

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# Bio



## **Alan Bickerstaff, Partner**

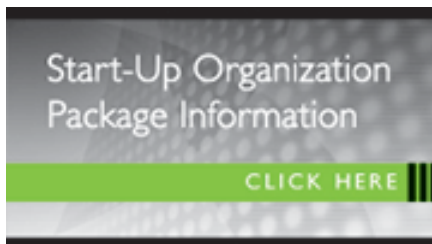
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Alan Bickerstaff is a Corporate and Securities partner who focuses on representing entrepreneurs and public and private emerging growth companies on formation, operations and corporate governance matters; securities law reporting and compliance matters; private equity and venture capital financings; public offerings and mergers and acquisitions.

Alan represents companies in a wide variety of industries, including the software, cleantech, internet, energy, semiconductor, renewable energy, life sciences, and telecommunications industries.

Alan has also represented numerous institutional investors in venture capital financings and private equity transactions as well as underwriters in various public securities offerings.

Alan has represented companies, venture capitalists and private equity sponsors in raising over \$600 million in capital in more than 100 venture capital and private equity financings. He has advised companies and underwriters in raising over \$2 billion in capital through initial public offerings, public equity and debt offerings and Rule 144A transactions, acquirers and targets in over \$2 billion of public and private company merger and acquisition transactions.

### **ANDREWS KURTH LLP Technology and Emerging Companies Group**

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