

Welcome to
RISE WEEK 2011

Seed and Angel Financing Strategies

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Overview

Basic Deal Structures

Angel Investor Issues

Common Pitfalls

Key Terms and Liquidation Preference Examples

Questions & Answers

Angel Investors

Angel Investors:

- Typically individuals; active/former entrepreneurs; often form networks
 - Invest \$25,000-\$250,000
 - May provide guidance and advice to founders/CEO
 - Many have become leery of deals that require institutional (VC) funding
- Angels want to “**lock in**” value of the investment or discount commensurate with risk while companies want to **defer** valuation until higher price can be justified (and want to do so using investors’ dollars)
 - Often request participation on the Board and/or in business oversight
 - Want to maintain rights & preferences in future VC rounds of financing
 - Finding them...
 - Angel Networks
 - Individuals
 - “Super angels”



Seed and Angel Financing Structures

Loans

Straight Loan – very simple “demand note” or term note

- no valuation needed
- no equity upside to investor
- rarely used (except by founders)

Convertible Bridge Loan – Defers valuation of company, but provides equity upside

- Type 1: No upside: Convertible at next round price & no warrant coverage
 - o Favorable to company but no “upside” for earliest investors
- Type 2: Warrant coverage: Convertible at next round price with X% warrant coverage
 - o Requires closing at least \$250,000 to avoid Texas state usury laws
 - o Type 1 and 2 most common
- Type 3: Convertible at discount to next round price **but** generally prohibited in Texas due to “usury” concerns (although frequently used)
- Notes can establish a “cap” on conversion value, so that investor gets the lower of cap or next round price



Seed and Angel Financing Structures

Usury:

- Texas Usury laws prohibit > 18% interest
 - o Interest includes all other benefits payable (e.g. next round discount); warrants included on <\$250,000
 - o Under Texas law, the penalty **TO THE INVESTOR** equals the greater of (1) 3x the difference between the amount charged and the amount legally permitted or (2) the lesser of \$2,000 or 20% of the principal
 - o Caveat: Usury concerns frequently disregarded by companies and investors
- Either type of note may be secured (but by what and why?)

Seed and Angel Financing Structures

Equity Issuances

Common Stock

- simplest structure with minimal transaction costs
- requires an implied valuation
- “taints” option price (i.e. company required to grant options with exercise price equal to common sale price)
- Offers no investor protection, so rarely used by sophisticated angels

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 angel investors but entails substantially higher transaction costs
 - o Use varies with size of investment

Equity allows investors to begin holding period for **long-term capital gains**

Equity qualifies for **Section 1202 Qualified Small Business Stock treatment**



Seed and Angel Financing Structures

Series Seed and Series AA Preferred Stock

- Simpler form of preferred stock touted as alternative to convertible notes
- Allows investor to “price” the investment while keeping transactional costs down
- Structure:
 - Simple Purchase Agreement (fewer representations, no legal opinion)
 - Standard Preferred Stock terms (perhaps with fewer protective provisions)
 - Simplified Investor Rights Agreement (with basic information and preemptive rights, perhaps board seat, and requirement to be granted rights to next round investor)
- Costs somewhat higher than typical convertible note but substantially lower than standard preferred stock round
- Generally economical (as compared to bridge notes) with \$500,000 investment



Common Seed Financing Pitfalls

- **Not bootstrapping enough (or long enough)**
- Selling Common Stock (setting option price), but granting options at lower price
- Investment by too many (or the wrong) friends, family and angel investors (administrative and management burden)
- Violations of state securities laws (especially sales to non-accredited investors); rescission rights
- Unrealistic expectations of inexperienced early investors (perhaps caused by optimistic projections -> potential fraud claims if investment sours)
- Previous unsupportable valuations (resulting in “down” round when VC invests)
- Unique or non-standard terms in seed financings that can require significant revisions
- Too many boards members and advisors (“hangers on”)
- Using brokers and finders



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 the founders of company purchase or typically receive at the creation of the company, usually for very low value (e.g. \$0.0001 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.

Preferred Stock – form of stock usually held by investors with rights and preferences superior to common stock, including liquidation preference, redemption and anti-dilution rights, board rights, information rights, and control over corporate actions (mergers, financing, etc.) by protective provisions (special voting rights)

Liquidation Preference – the rights 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 Protection – the right of preferred stock holders to maintain its fractional ownership percentage if shares are later issued at a lower valuation

Preemptive Rights – Right of an investor to continue to invest to maintain investor's ownership percentage



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	\$7,500,000	\$2,500,000

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	\$15,000,000	\$10,000,000

* 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 convert to Common

Seed and Angel Financing Strategies

Thank you!

Questions? / Open Discussion

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