Understanding Term Sheets and Deal Structures

Venture Capital Financing Overview

CED’s Entrepreneurs Only Workshop

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October 31, 2006
“Starting a company is like having a baby — fun to conceive but hell to deliver.”

- Anonymous
U.S. Fundraising On Track in 2006
Commitments to Venture Capital Funds

Source: Dow Jones VentureOne

YTD06*: 1Q06 - 3Q06
Investment Level On Track to Surpass 2005
Deal Flow and Equity into Venture-Backed Companies

Source: Dow Jones VentureOne/Ernst & Young

YTD06*: 1Q06 - 3Q06
Valuations Continue Upward Trend

Median Premoney Valuation by Year

<table>
<thead>
<tr>
<th>Year</th>
<th>Median Premoney Valuation ($M)</th>
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<tbody>
<tr>
<td>1995</td>
<td>$9.3</td>
</tr>
<tr>
<td>1996</td>
<td>$11.1</td>
</tr>
<tr>
<td>1997</td>
<td>$13.0</td>
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<tr>
<td>1998</td>
<td>$15.5</td>
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<tr>
<td>1999</td>
<td>$21.0</td>
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<tr>
<td>2000</td>
<td>$25.2</td>
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<tr>
<td>2001</td>
<td>$16.0</td>
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<tr>
<td>2002</td>
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<td>2003</td>
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<td>2004</td>
<td>$13.0</td>
</tr>
<tr>
<td>2005</td>
<td>$15.0</td>
</tr>
<tr>
<td>*YTD06</td>
<td>$18.8</td>
</tr>
</tbody>
</table>

Source: Dow Jones VentureOne

*YTD: 1Q06-3Q06
M&As Remain Primary Exit Option

Percentage Breakdown of Venture Backed Liquidity Events: IPO vs. M&A

YTD06*: 1Q06 - 3Q06

Source: Dow Jones VentureOne
Amount Paid in M&As on Track in 2006

Transactions and Amount Paid in M&As

Source: Dow Jones VentureOne
Older Companies Being Acquired

Median Time From Initial Equity Funding to M&A

<table>
<thead>
<tr>
<th>Year</th>
<th>1996</th>
<th>1998</th>
<th>2000</th>
<th>2002</th>
<th>2004</th>
<th>YTD06*</th>
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<tbody>
<tr>
<td>Years</td>
<td>4.7</td>
<td>3.5</td>
<td>3.0</td>
<td>2.9</td>
<td>2.5</td>
<td>2.1</td>
</tr>
<tr>
<td>Source: Dow Jones VentureOne</td>
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</tbody>
</table>

YTD06*: 1Q06 - 3Q06
IPO Activity Declines in 3Q’06

Deals and Total Amount Raised Through IPOs

Source: Dow Jones VentureOne
Half of 2006 IPOs from Vintage Year 2000

Median Time From Initial Equity Funding to IPO

YTD06*: 1Q06 - 3Q06

Source: Dow Jones VentureOne
Structure of Typical Start-Up

- Founders: Common Stock (Vesting Over Time)
- Employees: Common Stock Options (with Vesting Over 4 Years)
- Investors: Convertible Preferred Stock
Sources of Capital

- Self Funding (FFF)
- Angel
- VCs
- Corporate Investment
Angel Investors = High Net Worth

*Individuals with High Risk Appetite*

- Early stage preference
- Profile – “one and done”
- $25K - $50K
- Bell cows
- QBV Registration
- Endangered species
- Individuals (network)
- Organized Groups (PAN, CAP, CHAP, WIN)
Pro/Con on Angel Investors (Individuals)

- Terms offered by Company rather than investors
- Less demanding on terms and value
- Speed (quicker decisions; less due diligence)
- Follow-on issues
- Issues for VC’s
Current Angel Financing Environment

- $12.7 billion invested Q1 & Q2 2006
- 15% increase over 2005
- # of angel deals down 6%
- Average angel deal size up 22%
Venture Capital Requirements

- 25-30% Internal Rate of Return
- Market Size/Position
- Management Team “Bet on Jockeys, not Horses”
- Clear Exit Strategy
Past Funding Environment

Sophisticated Internet investor will give $CASH$ for vague promises.

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http://www.userfriendly.org/
Current Funding Environment

- Buyers’ (Investors’) Market
- Investors Buried with Deals
- Potential Exits Improving
- Valuations Creeping Up
- Terms Still Heavily Negotiated
4 Principles of Term Sheets

- **Valuation**: Percentage of Company
- **Control**: Board Composition, Protective Provisions and Restrictions on Founders Stock
- **Exit Strategy**:  
  - Redemption
  - IPO – Registration Rights
  - Acquisition – Liquidation Preference
- **Down-Side Protection**: Anti-dilution adjustment
Valuation Calculation

Capitalization

<table>
<thead>
<tr>
<th></th>
<th>Pre-Money</th>
<th>Post-Money</th>
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<tbody>
<tr>
<td>Outstanding Common Stock</td>
<td>2,000,000 shares</td>
<td>2,000,000 shares</td>
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<tr>
<td>Outstanding Preferred Stock</td>
<td>0 shares</td>
<td>2,000,000 shares</td>
</tr>
<tr>
<td>Outstanding Stock Options</td>
<td>250,000 shares</td>
<td>250,000 shares</td>
</tr>
<tr>
<td>Reserved Stock Options</td>
<td>750,000 shares</td>
<td>750,000 shares</td>
</tr>
<tr>
<td>Total Shares</td>
<td>3,000,000 shares</td>
<td>5,000,000 shares</td>
</tr>
</tbody>
</table>

Valuation:
(Series A Preferred Purchase Price = $2.00 per share)

$6.0 million

Series A invests $4.0 million to purchase 40% of the Company

$10.0 million
Control

Board of Directors

- Key Rights
  - Appoint and fire officers
  - Set policy/Make major decisions
  - Issue options

- Number of directors

- Investors: Election of BOD members by “series” or “class” vote
Control

Protective Provisions

*Must obtain approval of the Preferred to:*

- Authorize additional shares of stock
- Create a new series of stock with equal or greater rights
- Complete a merger/sale of assets
- Change the size of Board of Directors
Control

Typical Additional Investor Rights

- Information
- Co-Sale
- First Refusal (Pro Rata)
Exit Strategy - Redemption

- Forced liquidity: Zombie companies
- Timing: 3-5 years
- Amount (all at once or percentage)
- Forced exercise during certain period or “any time” after target date
- Statutory limits on share repurchase
Exit Strategy – IPO

Registration Rights

- Demand Rights
- S-3 Rights
- Piggy Back Rights
Exit Strategy – Acquisition

Liquidation Preference

- **Multiple of Liquidation Preference**
  - Preferred gets multiple times investment back before Common gets any money

- **Participating Preferred**
  - Preferred gets investment back first, remaining proceeds shared between Common and Preferred pro-rata

- **Limited or Capped Participation**
  - Preferred gets investment back first, remaining proceeds shared between Common and Preferred until Preferred reaches a multiple of investment (usually 2x – 5x) and remainder goes to Common

- **Non-Participating Preferred**
  - Preferred gets investment back first, remaining proceeds go to Common
Effect of Liquidation Preference

Gee Whiz Co. has 2,000,000 shares of Series A Preferred outstanding that was purchased for $1.00 per share and 2,000,000 shares of Common Stock outstanding. It has just been acquired for $15 million. How is the money divided?
Effect of Liquidation Preference

4x Multiple of Liquidation Preference with Participation:

Preferred receives 4x liquidation preference ($8 million) off the top. The remaining $7 million is split pro rata between the Common and Preferred ($3.5 million each).

Total return

  Preferred: 11.5 million
  Common: 3.5 million
Effect of Liquidation Preference

**Participation Capped at 4x:**

Preferred receives liquidation preference ($2 million) off the top. The remaining $13 million is split pro rata between the Common and Preferred until Preferred receives $8 million (i.e. $6 million each). The remaining $1 million goes to the Common Stock holders.

**Total return**

<table>
<thead>
<tr>
<th></th>
<th>Preferred:</th>
<th>$8 million</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Common:</td>
<td>$7 million</td>
</tr>
</tbody>
</table>
Effect of Liquidation Preference

Non-Participating Preferred:

Preferred receives liquidation preference ($2 million) off the top. The remaining $13 million goes to the Common, but because the Common holders will receive more than the Preferred holders, the Preferred holders will convert into Common and all holders will be treated equally.

Total return

Preferred: $7.5 million
Common: $7.5 million
Down-Side Protection

Anti-Dilution Protection

- **Ratchet**
  Conversion price of Preferred adjusted down to price of dilutive issuance (Largest adjustment)

- **Broad based weighted average**
  Conversion price of Preferred adjusted down based on a weighted average of outstanding securities, including options and warrants (Least adjustment)

- **Narrow based weighted average**
  Conversion price of Preferred adjusted down based on a weighted average of outstanding capital stock – does not include options and warrants (Medium adjustment)
Down-Side Protection

Don’t Forget Exclusions

- Option pool of limited size
- Mergers/acquisitions
- Warrants for banks/leasing companies
- Strategic transactions
Anti-Dilution Calculation

Facts:
Gee Whiz Co. has 3,000,000 shares of Common Stock, 5,000,000 shares of Series A Preferred Stock and options to purchase 2,000,000 shares of Common Stock outstanding. The Series A Preferred Stock was sold at $1.00 per share. Gee Whiz Co. now would like to issue 4,000,000 shares of Series B Preferred Stock at $0.50 per share. How is Series A Preferred Stock affected?
Anti-Dilution Calculation

Ratchet:

Series A initially converts to Common on a one-to-one ratio based on its purchase price $1.00/$1.00. After the issuance of Series B, the conversion price is ratcheted down to $0.50. As a result, the new conversion ratio is calculated as follows: $1.00/$0.50 (or 1:2). So, for every 1 share of Series A converted, the holder will receive 2 shares of Common. Consequently, the 5,000,000 initial shares of Series A now convert into 10,000,000 shares of Common.
Anti-Dilution Calculation

Broad-Based Weighted Average:

Formula: \( \frac{(\text{all outstanding securities}) \times \text{Conversion Price} + \text{Amount Raised}}{\text{All outstanding securities} + \text{New Securities Issued}} \)

Calculation: \( \frac{(3,000,000 + 5,000,000 + 2,000,000) \times 1.00 + 2,000,000}{3,000,000 + 5,000,000 + 2,000,000 + 4,000,000} = 0.8571428 \)

Conversion Ratio: \( \frac{1.00}{0.8571428} = 1.166 \)

So, the 5,000,000 shares of Series A will convert into 5,833,333 shares of Common Stock.
Anti-Dilution Calculation

Narrow-Based Weighted Average:

Formula: \((\text{Common} + \text{Preferred}) \times \text{Conversion Price} + \text{Amount Raised}) / (\text{Common} + \text{Preferred} + \text{New Securities Issued})\)

Calculation: \((3,000,000 + 5,000,000) \times 1.00 + 2,000,000 \) / \(3,000,000 + 5,000,000 + 4,000,000\) = 0.8333333

Conversion Ratio: $1.00 / $0.8333333 = 1.2

So, the 5,000,000 shares of Series A will convert into 6,000,000 shares of Common Stock.
Pop Quiz

- Company A raises $2 million at a $2 million pre-money valuation.
- Company B raises $3 million at a $4 million pre-money valuation.
- Which Company got the best deal?
- It depends on the terms!
A Tale of Two Companies

Both companies financed under exactly the same conditions:

**Initial Capitalization**
3,000,000 founders shares
2,000,000 shares initial reserved for options

**Series A Financing**
Company raises $5M at a $5M pre-money valuation

**Series B Financing**
Company raises $2M at a $5.5M pre-money valuation (and adds 1M shares to option pool)

**Series C Financing**
Company raises $21M at a $63M pre-money valuation (and adds 1M shares to option pool) at a $84M post-money valuation
Key Financing Terms

**SmartCo**
- Narrow-based weighted average anti-dilution protection
- Participating Preferred capped at 4x Liquidation Preference

**SlowCo**
- Ratchet anti-dilution protection
- 4x Participating Preferred with no cap
## Cap Tables Following Financing

<table>
<thead>
<tr>
<th></th>
<th><strong>SmartCo</strong></th>
<th></th>
<th><strong>SlowCo</strong></th>
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<tbody>
<tr>
<td>Common</td>
<td>3,000,000</td>
<td>Common</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Options</td>
<td>4,000,000</td>
<td>Options</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Series A</td>
<td>5,000,000 (6,000,000)</td>
<td>Series A</td>
<td>5,000,000 (10,000,000)</td>
</tr>
<tr>
<td>Series B</td>
<td>4,000,000</td>
<td>Series B</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Series C</td>
<td>5,666,666</td>
<td>Series C</td>
<td>7,000,000</td>
</tr>
</tbody>
</table>

**Common Ownership:** 13.24%  
**Common Ownership:** 10.71%
Payout Scenarios

- **How much $ do the Common holders get in a $40 million acquisition?**
  - SmartCo: Approximately $1.6 million (or 4%)
  - SlowCo: -0-

- **A $100 million acquisition?**
  - SmartCo: Approximately $10.5 million (or 10.5%)
  - SlowCo: -0-

- **A $200 million acquisition?**
  - SmartCo: Approximately $23.7 million (or 11.85%)
  - SlowCo: Approximately $9.4 million (or 4.7%)

- **A $500 million acquisition?**
  - SmartCo: Approximately $66.2 million (or 13.24%)
  - SlowCo: Approximately $41.6 million (or 8.32%)
Moral of the Story

In order to know if that new Term Sheet you received is a Trick or a Treat – You have to know your terms!
Questions?

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