WILEY FINANCE

The Business of VENTURE CAPITAL

Insights from Leading Practitioners on the Art of Raising a Fund, Deal Structuring, Value Creation, and Exit Strategies

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Chapter 8

The Basics of Corporations, Ownership, and Control

> I wasn't a founder in the sense that I contributed anything scientifically but in the sense that I signed the corporation papers and owned founder's stock.
>
> —*Arthur Rock, early investor in Apple, Intel*

Nowhere is the desire for ownership more heightened when you consider blazing new companies like Facebook, Zynga, or Twitter. For a rookie practitioner, it is important to understand the basics of ownership and control. Assume Jack and Jane decide to form a start-up called NewCo. Jane's idea promises to be the next big thing and Jack, with his proven skills and expertise, is eager to help execute that vision. He quits his $250,000-a-year job to join NewCo. The two shake hands and split the ownership 60:40.

The first step is to agree on how business decisions will be made, and the second step is to incorporate the company. The control feature comes into play with the business decisions. The economic feature relates to shares and cash—the value of the enterprise, share price, preferences and classes of shareholders, and how the cash spoils, if any, will be distributed. As simple as it may seem, it is easy to confuse ownership and control: A shareholder who owns shares of Google is eligible for the economic spoils (the ability to buy low and sell high, to receive

dividends, and to take advantage of stock splits) but does not decide how the company is operated. On the other hand, a COO may have control of the operating decisions but have little or no ownership in the company.

The two documents that must be drafted when any company is being formed are:

> **1.** *The Certificate of Incorporation:* Filed with any state, this is a license to establish the entity.
>
> **2.** *The Articles of Incorporation (or corporate bylaws):* The Articles are generally the supreme governing document of any company and contain the most fundamental principles and rules regarding the nature of the company. The Articles regulate the form, manner, and procedure in which a company should be run. At the time of formation, a corporation's founders execute the Articles, which generally cover topics such as how directors are elected, how meetings of directors (and shareholders) are conducted, and how officers are elected and should carry out their duties. Typically, the Articles cannot be amended by the board of directors; instead, a supermajority vote of all the shareholders, such as a two-thirds vote, is usually required for amendment. The rights of shareholders, and how these differ from those of the board, are discussed here.

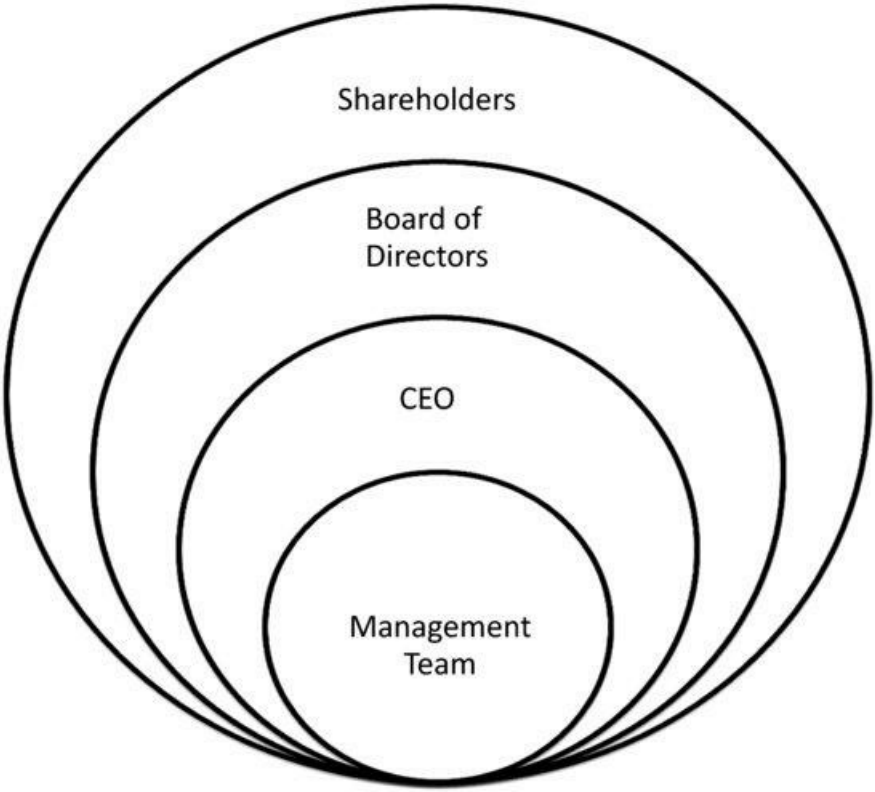
Let's assume Jack and Jane choose to form a C Corporation and domicile it in Delaware. In the United States, a Certificate of Incorporation is filed with a state government division; in

Delaware, it is filed with the Delaware Division of Corporations.[1] The state division needs to know the name of the entity, the location of the registered office, the number of authorized shares, the par value, and the name of the incorporator.

Jack and Jane choose to establish a pool of 100,000 shares of stock. Note that this is an arbitrary number. It could be 100 shares or 1 million shares. Two aspects come into play while selecting this number of shares. First, human psychology—it is better to own 60,000 shares than, say, 60 shares. The smarter ones focus on percentages, but I have been surprised how many times this "small number" has become an issue. Second, some states tax entities on the number of authorized shares, their par value, or a combination thereof. Called the franchise tax, each state has its own method for calculating this madness. In Delaware, for 100,000 shares, the franchise tax is $825. If the founders had authorized 5,000 shares, they would have paid only $75 in franchise tax[2] (and would likely have had to deal with the psychological issues).

At the point where investors come in, two events will occur. Initially, the Articles of Incorporation will be amended to describe the board's structure and composition (see Figure 8.1). These define the control aspects. The number of authorized shares would increase and the classes of shareholders may change, which would define the economic aspects of the investment.

Figure 8.1 Rights and Responsibilities of a Corporation Are Shared between Various Stakeholders



My creativity is clearly lax when it comes to names—Jack, Jane, and NewCo—but the objective of this chapter is to help a reader understand the basics of ownership and how capitalization tables are constructed.

AUTHORIZED SHARES AND ISSUED SHARES

At the time of incorporation, NewCo is established with a predetermined number of shares. This is an arbitrary number determined by the founders. These shares, called *authorized shares*, are quantified in the company's articles of incorporation.

At the time of formation, there will likely be only one class of shares: common. Investors typically seek preferred shares, and I will discuss the differences between the two classes in due course.

From the pool of authorized shares, all shares issued to founders, investors, or other parties are called issued shares. Issued shares are also termed *outstanding shares.* From the preceding, it is obvious that the number of authorized shares will always be equal to or more than the issued and outstanding shares. Treasury shares, not as pertinent to start-ups, are shares that have never been issued and do not have any voting rights.

Preferred Shares versus Common Shares

To understand the preferences of preferred shareholders, consider a balance sheet of a corporation, which lists assets, liabilities, and equity. Notice in Table 8.1 the overall context of risk, target returns, and the position of the preferred shares. At the top of the balance sheet is the secured lender, say a bank, which has first rights to collateral for the value of the secured debt. As the bank is "senior" to all and secured, its risk is considered the lowest. Thus, the rate of return expected by a secured lender is a much smaller percentage as compared to the unsecured lenders or stockholders.

Table 8.1 Balance Sheet, Preferred and Common Stockholders

Assets	Liabilities	Remarks	Risk	Target Annual Returns (%)
Cash	Debt			
Receivables Long-term assets Intellectual property	Secured debt Unsecured debt Subordinated and convertible debt	Debt holders have priority lien on assets of the company. As the collateral decreases, risk increases, and target returns increase.	Lowest risk Medium risk	6 12 14
	Equity			
	Preferred stock—Series B Preferred stock—Series A	Preferred stock enjoys higher economic benefits via liquidation and antidilution; it behaves like debt in early stages and converts to common stock as risk is reduced and eliminated.	Higher risk—typical structure for venture investments	20 30
	Common stock	Only minimum economic benefits of dividends	Highest risk— typical structure for founders	

Suppliers/payables are clubbed under unsecured debt. Stockholder preferences create a pecking order, especially with

respect to liquidation preferences. Series B or later-stage investors have lower risk relative to Series A and thus target a lower rate of return. Common stock holders are at the bottom of the proverbial totem pole and are last to receive any liquidation proceeds. Management and founders are typically in this category.

Investors will seldom accept common shares, the lowest form of security with no significant control provisions. The two preferences all major investors seek are: economics and control. “If both investors and founders are at the same level of ownership and hold common shares, a problem exists,” writes Dr. David Brophy,[3] who heads the University of Michigan Center for Venture Capital and Private Equity.

“The use of common shares bestows not only 50.1 per cent of the economics [for the founders], but also 50.1 per cent of the control of all aspects of the firm's management. With this voting majority, the founder ‘wins all votes’ and effectively controls the company. Both parties, however, may argue that some or all of the control should rest with the investor in order to mitigate the management risk. Usually, failure to accommodate this demand by the investor would be a ‘deal-breaker,’ ” writes Dr. Brophy. The answer: convertible preferred shares. Preferred shares are a separately established class in the articles of incorporation that enjoys control and financial preferences above common shareholders. The convertible feature allows the preferred shares to convert to common under certain conditions, ideally at the time of an exit when risk is minimized.

Ownership Dynamics and the Capitalization Table

A capitalization table, or a cap table, lists the ownership of shares by name, class of ownership, percentage, and number of shares. It allows the investors and the company to understand the ownership structure. Consider Table 8.2, which demonstrates a cap table of a newly formed company with two founders. Let us term this as Phase I of the company. As we progress, note that while the ownership is negotiated in percentages, the subsequent calculations lead to the number of shares and per-share prices.

Table 8.2 Phase I—Founders Only: NewCo Capitalization Table

Name of Shareholder	# Shares	Price	Paid-Up Value	Percent Ownership
Jane	60,000	$0.001	$60.00	60
Jack	40,000	$0.001	$40.00	40
Issued and outstanding shares	100,000	—	$100.00	100

The price per share is established at a nominal value of $0.001, as the enterprise has little or no value at the time of its launch. The paid-up capital is thus $100.

Let's now move into Phase II of this company's growth, where a CEO is invited to join the team. Ms. CEO negotiates a 10 percent ownership in the company. Table 8.3 shows the resulting capitalization and ownership.

Table 8.3 Phase II—Hiring of CEO: Dilution of 10 Percent

Name of Shareholder	# Shares	Price	Paid-Up Value	Percent Ownership
Jane	60,000	$0.001	$60.00	54
Jack	40,000	$0.001	$40.00	36
Ms. CEO	11,111	$0.001	$11.11	10
Issued and outstanding shares	**111,111**	—	**$111.11**	**100**

In this situation, we can see that the number of shares owned by the founders, Jack and Jane, remains the same, but the percentage of ownership changes. The company has now increased its pool of authorized shares to 111,111. Both the founders have tasted dilution—a dreaded word in entrepreneurial jargon. However, as we will see, dilution is acceptable so long as the enterprise value increases with every step of dilution.

In Phase III, a Series A investor is eager to invest. The investor and the founders agree to a premoney valuation of $1.0 million. The investor seeks preferred shares—a new class of shares. Consider Table 8.4 with certain assumptions. Two scenarios are presented where the amount of Series A investment is $500,000 for one scenario and $900,000 for another.

Table 8.4 Phase III: Impact of Series A Investor

Assumptions:		
Premoney enterprise value established (A) =	$1,000,000	$1,000,000
Amount of investment (B) =	$500,000	$900,000
Postmoney enterprise value = (C) = (A + B)	$1,500,000	$1,900,000
Percentage ownership to Series A Investor = (B) / (C) =	$500,000/ $1,500,000 = 33%	$900,000/ $1,900,000 = 47%

Name of Shareholder	Paid-Up Value	Percent Ownership	Paid-Up Value	Percent Ownership
	$500,000 Investment		$900,000 Investment	
Jane	$60.00	36	$60.00	28.4
Jack	$40.00	24	$40.00	18.9
Ms. CEO	$11.11	7	$11.11	5.3
Series A investor ownership	$500,000	33	$900,000	47.4
	$500,111.11	100	$900,111.11	100

If the amount of investment increases, it causes further dilution for the founders. Investors and entrepreneurs need to balance the capital infusion and ownership with due caution. Investors are motivated to buy low. However, the amount of capital invested should be based on reasonable assumptions of milestones and should be sufficient to create a value inflection for the company. Compare the four scenarios in Table 8.5.

Table 8.5 Impact of Dilution at Various Stages

	Founders and Management		Series A Investment	
	Founders Only	Founders and CEO	Amount $500,000	Amount $900,000
Jane	60%	54%	36%	28.4%
Jack	40%	36%	24%	18.9%
Ms. CEO		10%	7%	5.3%
Series A			33%	47.4%
Enterprise value	$100	$100	$1,500,000	$1,900,000

While the example is highly simplistic, the objective of the exercise is to demonstrate that (1) dilution occurs as newer

entrants arrive and (2) dilution is good so long as the value of enterprise increases at every stage of dilution.

Let us assume a $900,000 investment and add a layer of employee option pool to this mix of ownership. Further, let us assume the investor and the founders agree to set aside a 10 percent option pool to attract future management. Table 8.6 shows the modified capitalization table.

Table 8.6 Impact of Employee Option Pool Creation: Before and After Financing

	Founders and CEO	Option Pool Created Prior to Financing	Option Pool Is Diluted Post-financing	Option Pool as 10% of Postfinancing Capitalization
Jane	54.00%	48.60%	25.76%	22.90%
Jack	36.00%	32.40%	17.17%	15.26%
Ms. CEO	10%	9.00%	4.77%	4.24%
Series A Investor			47.60%	47.60%
Option Pool		10.00%	4.70%	10.00%
Total	**100%**	**100%**	**100%**	**100%**

By adding the option pool *postinvestment*, the investor's ownership was diluted as well. Thus, option pools are negotiated premoney (the equity for the option pool comes from the founders' pockets and not the investors' pockets) and agreed on prior to closing but come into effect post-financing. It is customary to add language to the term sheet that states that "*the company will create an option pool so that it composes 10 percent of the postfinancing capitalization*." This avoids dilution for investors. For founders, it is customary to negotiate the size or percentage of the pool. The effective valuation for the investors drops by the percentage of the pool and investors should ensure

that entrepreneurs are aware of this impact.

As Mark Suster, who has sold two companies and is now a partner with GRP Ventures, writes:

> When I was raising capital as an entrepreneur, I had several term sheets and I thought I knew every term … somehow I still got a bit duped. One of the leading term sheets had an option pool of 40 percent in it. I couldn't understand why until a friend pointed out that this just lowered the true pre-money valuation. Nowhere on the term sheet could I find the true pre-money or effective pre-money … that was left for me to calculate.[4]

While each shareholder owns a certain percentage, if the options were exercised to their maximum 10 percent, each shareholder would be "fully diluted." Fully diluted ownership is defined as the ownership after all options and any warrants would be exercised. Thus, in Table 8.6, the far right column, "Option pool as 10% of postfinancing capitalization," indicates fully diluted ownership. If options stay in the pool and are not fully utilized, and an exit was to occur, founders and Series A investors could find themselves with a bit of a bounty. A simple way to sort this out is to offer the unutilized portion back to the founders. After all, it came out of their pockets.

SHAREHOLDER RIGHTS

Shareholders generally enjoy the following rights, which are *distinct from the powers of the board of directors*:

- Shareholders must approve any changes made to the corporation as a whole. For example:
    - The articles of incorporation would be amended when any investment is made and additional shareholders are authorized.
    - A change to a corporation's bylaws would affect the shareholders. In one case, a simple oversight in bylaws led to undue inefficiencies. The bylaws of a company did not specifically mention that shareholder communication could be conducted via e-mail or that shareholder meetings could be conducted remotely. The start-up had to endure pain as it printed books, shipped them, and waited patiently to receive the signature pages. This was eventually corrected via a modification of the bylaws—an expensive and time-consuming oversight.
    - Acquisitions: All shareholders have rights related to the assets of the corporation and thus must approve the transfer of assets.
    - Stock/transfer of stock: For example, a board may authorize creation of an employee option pool; however, all shareholders would approve such a

creation.

- Shareholders can sue the corporation for wrongful acts by the directors and officers of the corporation. This is lost on many rookie venture capitalist board members. This is the reason why director and officer (D & O) insurance exists and why indemnity clauses are important.

- Shareholders have the right to inspect the records and books of the corporation.

- Shareholders have the right to receive dividends as declared by the board of directors of the corporation.

- Shareholders have the right to approve or disapprove corporate transactions where some directors have a conflict of interest.

ROLE OF THE BOARD

The board is responsible to and primarily represents *all* shareholders (not just investor A or B). A venture-backed board member is responsible for ensuring that shareholder value is sustained and enhanced. The board is also primarily responsible for assessing CEO performance and assisting in recruitment, transition, and succession planning. Additionally, the board must

establish good governance practices.

SUMMARY

In summary, the corporation as an entity is owned by its shareholders, governed by a board of directors, and managed by the CEO. The board members act as representatives of all shareholders and are legally bound by duties of care and loyalty. The corporation's ownership varies as depicted in the capitalization table dynamics.

The goal of this chapter was to provide a simple overview of the ownership dynamics and its impact of the capitalization table. Let us proceed to valuation, that voodoo art of prescribing a tangible number to the dreams of two guys in a basement with a PowerPoint presentation.

Chapter 9

Valuation Methods and Other Voodoo Arts

> The price was way too high but sometimes that's what it takes to do the deal.
>
> —*Jim Bryer, on Accel's $12.7 million investment to acquire 15 percent of Facebook at ~$100 million premoney valuation.*[1]

While valuation is one of the important terms for the entrepreneur as well as the investors, no simple method exists to calculate valuation at the seed and early stage of investments. "Sounds about right" is often an expression used by practitioners when numbers are tossed around. Depending on the stage of the company, valuation can be a simple back-of-the-envelope calculation, net present value calculation, or comparable transactions, called "comps." This chapter briefly covers the approaches to valuation. However, the emphasis is more on the subjective art at an early stage, rather than formulaic net present value (NPV)/discounted cash flow (DCF) approach.

Valuing an early-stage company is a nebulous exercise—an art form at best. Aswath Damodaran, author of "The Dark Side of Valuation," writes, "There can be no denying the fact that young companies pose the most difficult estimation challenges in valuation. A combination of factors—short and not very informative histories, operating losses and the … high probability of failure—all feed into valuation practices that try to avoid

dealing with the uncertainty by using a combination of forward multiples and arbitrarily high discount rates."[2]

HOW TO VALUE INTEL: LESSONS FROM ARTHUR ROCK

Bob [Noyce] called me one day and said, "We're thinking of leaving {Fairchild Semiconductor} to form a company," and I asked him how much money they thought they needed to get started, and they said, "$2.5 million." And I said, "Okay. You got it." No—first, I think we first discussed the terms—how much of the company they would be willing to give to investors for putting up $2.5 million, and we agreed on 50 percent. Then I said, "Okay, you're covered," and went about raising it.

Source: Arthur Rock, interview by Sally Smith Hughes, 2008–2009, "Early Bay Area Venture Capitalists: Shaping the Economic and Business Land-scape," accessed February 10, 2011, http://digitalassets.lib.berkeley.edu/roho/ucb/text/rock_arthur.pdf.

THE DRIVERS OF VALUATION

By aligning the valuation drivers with the prior steps of the due diligence, we can see that in order of priority, the valuation will tend to be higher when all the following criteria are met:

- The opportunity serves an *attractive market* with higher *growth potential*.
- The opportunity has *an established competitive position* via patents or market share or leadership.
- A *strong team* is in place or, as Rob Hayes of FirstMark

Capital puts it, it has "an execution machine."

- The opportunity may demonstrate *capital efficiency* (needs lower amounts of capital to achieve financial independence), revenues, gross margins.

- A meaningful *exit potential within the target time frame* can be achieved: There is a universe of strategic buyers that is large, accessible, and seeks growth opportunities via acquisition.

- Finally, the state of the market frothiness, or excessive capital supply, can often elevate valuations across the board and trounce all of the above criteria.

THE SIMPLIFIED FORM OF THE VC METHOD OF VALUATION

Harvard Business School Professor William Sahlman's VC method of valuation begins with the end in mind. Consider Table 9.1. Current market trends of 2009 state that if you are investing $800,000 in a seed stage company, your ownership will be in the 26 percent range. This rule of thumb works well when you are dealing with very early-stage companies with little or no meaningful comparable data. Also, consider data trends in Figures 9.1 and 9.2.

Table 9.1 Example of Simplified Valuation Method

Scenarios	Home Run	Not Bad	Phew
Estimated value of VC ownership at exit, assuming dilution from 26%	20%	5%	2%
Estimated value of company at year 6	$150 M	$75 M	$25 M
IRR	106%	36%	4.5%
Cash-on-cash multiple	37.5	4.68	1.25

Starting with some data, we know that:

Median time to liquidity via an acquisition = 5.5 years

Median premoney valuation of seed round = $2.3 million

Median amount of investment at seed stage = $800,000

Imputed VC ownership at the time of investment = 26 percent

To generate a target IRR of, say, 106 percent, you need to retain, or preserve ownership to, as much as 20 percent. On the lower end of the spectrum, with a 36 percent IRR, you would be expected to retain at the minimum of 5 percent. Thus, the simple exercise should allow any practitioner to assess whether the investment opportunity can realistically help reach the target IRR by preserving ownership until an exit point is reached. Preservation of equity depends on a number of variables, and not all can be predicted. Thus, while negotiating valuation, any practitioner keeps the following three variables in perspective: Timing of exit, Ownership at Exit and Target IRR. Lets expand on these:

Figure 9.1 Median Equity Financings for U.S. Venture-Backed

Companies

Source: Dow Jones VentureSource.

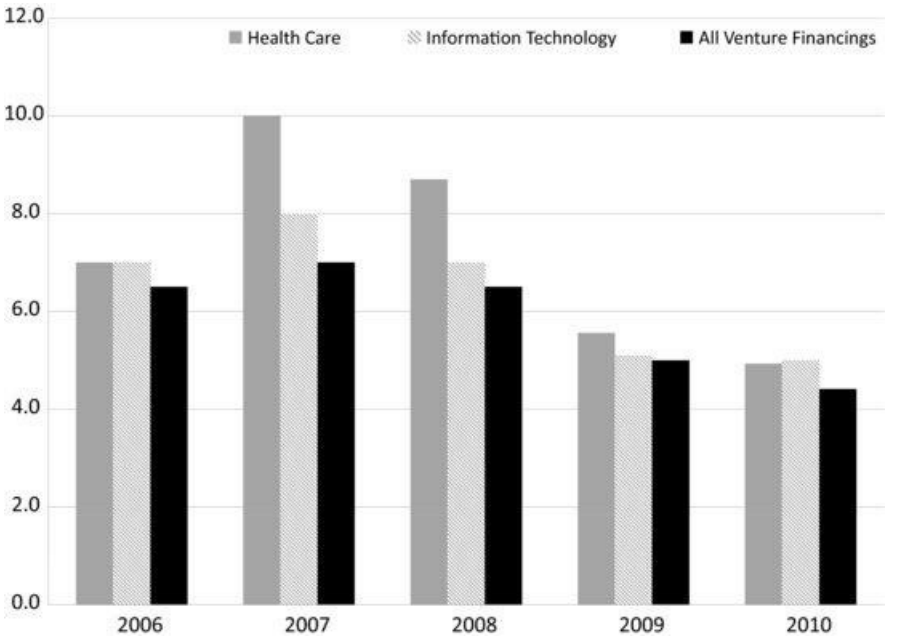
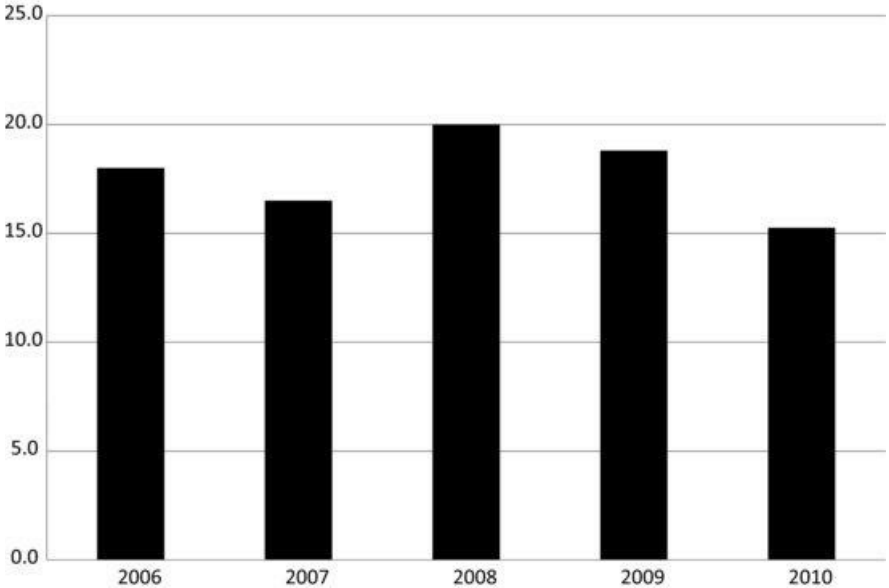


Figure 9.2 Median Premoney Valuation for U.S. Venture-Backed Companies

Source: Dow Jones VentureSource.



1. The timing of the exit depends on several factors, both internal and external.

a. Internal factors:

i. Resources, including management team quality and cash resources: Any rapid churn in the management team, unforeseen uses of cash, and changes in the burn rate will significantly affect the timing and value of the exit.

ii. Ability to execute and meet milestones

iii. Strategy and business model

iv. Investor's desire to force an exit: Many practitioners need to show exit activity to allow for future fund-raising success.

b. External factors:

i. Competitive threats

ii. Acquirer industry dynamics

iii. Public market/macroeconomic conditions

2. The estimated VC ownership at exit: Ownership at exit depends on value creation vis-à-vis burn rate. All practitioners aim to minimize future dilutions. Some common sources of nondilutive capital infusion include:

a. Strategic relationships: Joint development agreements within the pharmaceutical sector are common. The start-up gets access to a funding stream in exchange for exclusive distribution rights.

b. Venture debt: When Facebook wanted to raise $3 million, right after raising $12.7 million, Western Technology Investment offered venture debt. This form of financing reduces the overall cost of capital for start-ups and preserves equity for current owners. Venture debt is a hybrid form of financing available to certain types of venture-backed companies. As it is considered higher risk, venture debt financiers usually seek collateral, a higher rate of return, and warrants to sweeten their rate of return.

c. Federal and state grants: A range of options are available, but restricted to technology-intensive companies for conducting research and development activities. The Small Business

Innovation Research (SBIR) and Small Business Technology Transfer (STTR) federal funding programs offer grant opportunities each year. While these depend on funding availability for agencies and are hypercompetitive, several start-ups have opportunistically gained traction with such grants.

3. The exit value of the company: While this value can be guesstimated, as most practitioners say, focus on building something of value, and exits take care of themselves. Practitioners typically target a minimum threshold of IRR, say 35 percent, for each opportunity and, based on projections and exit probability, choose to invest or pass on opportunities.

In summary, the valuation economics boil down to (1) minimizing dilution and (2) maximizing exit value. Some practitioners alleviate all these concerns and try to squeeze as much equity as possible at the early stage, that is, maximum ownership at the lowest valuation. But this approach can come back to bite you. As Rick Heitzmann, managing director, FirstMark Capital, says, "Valuation matters. But you cannot get too focused on it. You get a sense of people when they fight for the last nickel—this is a like a marriage and the goal is to keep the big picture in mind. Entrepreneurs do not always take the highest offer but select the best partner, and we have found that the combination of our experience and networks creates a far superior value proposition to just offering money."[3]

COMPARABLE VALUATIONS OF SIMILAR INVESTMENTS (COMPS)

In the comparable valuation or "comps" method, valuation is determined by comparable transactions in the marketplace. Consider Table 9.2, which shows a typical range of values. The revenues and the acquisition price are estimated, as these may not be declared or available publicly. A median and mean multiple is calculated that indicates a range of multiples that could be deployed in such a scenario.

Table 9.2 Sample Comparable Method (Private Companies)

Company	Acquisition Price	Date of Acquisition	Estimated Revenue	Multiple
Accio Energy, USA	$550M	Jan 2013	$50M	11×
Premier Solar, Germany	$225M	July 2012	$28M	8×
Gemini Global, USA	$155M	Dec 2010	$26.2M	5.9×
Pantera Premier, Spain	$40M	June 2011	$2M	20×

I n Table 9.3, the universe of publicly traded companies is assessed. While the data is available, critics argue that the method does not factor in several risks such as technology, market adoption, and liquidity risks. Further, the growth rates and gross margins for each company are different.

Table 9.3 Sample Comparable Method (Publicly Traded Companies)

Company	TTM Revenues	TTM EBITDA	Market Cap	Enterprise Value	Enterprise Value (X Rev)	Enterprise Value (X EBIT)
General Energy	670	73	1,640	1323	2.0	18.1
Second Solar Group	433	99	1776	1220	2.8	12.3
Avalon Energy	1229	114	4440	3600	2.9	31.6
Sapphire Technology	225	45	800	990	4.4	22.0

While this method is used broadly in later stage companies, it

has its own set of fair challenges:

- *The universe of comparable transactions may be broad*: As they say, with a large dataset, you can draw any conclusion you desire. When entrepreneurs present comparable transactions, and when investors dig the dataset, valuations can be surprisingly different.

- *Lack of transparency*: While the only data available is the premoney valuation, the data does not depict the finer nuances of strengths and risks embedded within. For example, valuation skews toward the positive when an experienced entrepreneur may be leading an opportunity. Other factors that may affect value are the quality of technology estate and its attractiveness to customers or existing partnerships—these factors may be invisible from the comps dataset.

- *The comparable dataset in a frothy environment may create a lemmings effect*: In the year 2000, the median premoney valuation at first round was $8 million. By 2010, it had dropped to $4 million.

VALUATION AND THE ART OF GETTING A SEAT AT THE TABLE

Early-stage investors can seldom predict whether an opportunity will grow, gain momentum, and generate returns. A classic investment approach is to invest a small

amount and gain a seat at the table. "You are buying an option to invest in future rounds," says Jim Plonka of Dow Venture Capital. And if the company begins to grow, investors could maintain or build up their ownership position by investing additional amounts in future rounds. Consider when Sabeer Bhatia, founder of Hotmail, met with Draper Fisher Jurvetson (DFJ) to pitch his idea. Like most entrepreneurs, he asked for valuation in nice round numbers: $3 million. That was the heyday of the dot-com boom, and neither DFJ nor Bhatia would have the time to debate comps, develop intricate financial models, and craft the correct "ask" amount. Rather, DFJ followed the classic move of buying a seat at the table and putting in enough chips.

Tim Draper asked, "How much money do you need just to prove to us that you can do this—that it's even possible to make e-mail available on the web?" Draper asked for 30 percent of the company for $300,000; Bhatia pushed back and they agreed on 15 percent, with an implied postmoney valuation of $2 million.

DFJ was able to invest a small amount and test the hypothesis as well as the team's mettle. DFJ invested additional capital in future rounds and 20 months later, Hotmail was acquired by Microsoft for approximately $400 million.

Source: Adapted from Jessica Livingston, Founders at Work: Stories of Startups' Early Days (Berkeley, CA: Apress, 2007), 20.

DISCOUNTED CASH FLOW METHOD

If you have a master's in business administration, the DCF valuation technique would have been drilled into the depths of your cranium. If you do not have an MBA, you could review the following techniques, but like most highly academic techniques, the DCF is irrelevant for early-stage VC on a number of counts. For one, at an early stage of any company, you really do not have comparable data and the rest is projections—thus, I have seen entrepreneurs conjure up projections and use extensive DCF models to develop precise valuation, a healthy exercise, but at the end of the day, value is what can be transacted upon. A great model with multiple Excel spreadsheets is helpful, but if a

transaction cannot be consummated, what good is all this idealism?

To calculate valuation of a firm using DCF, we estimate growth rate—the percentage of growth and the number of years of such growth. (Therein lies caveat #1.) The entrepreneur's estimates and practitioners' estimates can vary significantly. But let us assume that the two come to some mutual ground. The second variable is free cash flows (FCF) available during such a period. FCF seems like a novel concept when we discuss start-ups and early-stage companies. Finally, we assume a discount rate—you consider the terminal value and those FCFs, and pull them all together to the present date. That rabbit you pull out of your hat is called Net Present Value (NPV)—a formula that is an amalgamation of four different projected variables—the rate of growth, the time period of growth, the cash flows, and the cost of capital. The closest I can come to assessing, on any given day, is that just one variable equals the cost of capital. But the rest seems like voodoo to me. Allow me to humor you for a bit longer:

When all is said and done, you are trying to establish a value for the existing assets and future growth. The approach is well suited for more mature companies. Start-ups have little or no revenues, no customers, and at times, operating losses. Even those young companies that are profitable have short histories, and most young firms depend on private capital, initially owner savings, and VC and PE later on. As a result, many of the standard techniques we use to estimate cash flows, growth rates, and discount rates either do not work or yield unrealistic numbers.

In addition, the fact that most young companies do not survive has to be considered somewhere in the valuation. Researchers studied the survival rate of 8.9 million firms over a seven-year period (1998–2005) and concluded that only 38 percent of businesses survived over a five-year period. See Table 9.4, which shows the survival rate of technology companies (clubbed under "Information"), which is substantially lower than health services.[4] At least two-thirds of technology companies die in five years, a higher mortality rate as compared to health services.

Table 9.4 Survival Rate of Firms

Sector	Year 1	Year 5	Year 7
Health Services	86%	50%	44%
Information	81%	31%	25%
Financial Activities	84%	44%	37%
Business Services	82%	38%	31%
All Firms	**81%**	**38%**	**31%**

Damodaran suggests that besides using "a combination of data on more mature companies in the business and the company's own characteristics to forecast revenues, earnings, and cash flows," we should "adjust the value for the possibility of failure."[5] Value is based on future revenues on the assumption the business survives. Hence, the possibility of failure needs to be factored into the equation. He further points out that multiples of valuation should be considered at the point of exit, rather than present-day multiples. If the revenue of a start-up after year 5 were to drop to a compound annual growth rate (CAGR) of 10 percent, the multiple should reflect this growth as opposed to, say, 50 percent CAGR in earlier years. This would create an interesting conundrum where, besides revenues, practitioners would try to project the exit multiple five years down the road.

While this may not be adopted as easily, most practitioners use a rule of thumb to assert valuation while considering risks of technology failure, management churn, financing risk, and illiquidity premium. As one GP pointed out, "I expect each of my portfolio companies to generate 10X returns and make the fund whole—getting caught up in discount ratios and valuation techniques does help. I seek the best in class and work hard to make them the *numero unos* of their category." As Michael Moritz of Sequoia Capital once remarked, "We are in the business of creating a large bonfire with a small matchstick."

SUMMARY

Establishing a price for an illiquid security, with significant risk (management risk, market risk, technology risk, follow-on financing risk) is nebulous activity. At the early stages of investment, practitioners have honed the valuation process to an art form, a subjective technique at best. For most practitioners, the ability to generate returns is what matters. And for each investment, seasoned investors seek 10x or higher returns. "I want each of these to have the potential to be a 10-bagger and make my fund," one GP remarked. Should the valuation debate become prolonged, consider using a blended approach with others terms. An interesting approach that diffuses valuation—called springing warrants—is discussed in the following chapter. As most agree, valuation is just a small part of the overall structure.

As far as Jim Bryer goes, he may have felt the investment was expensive at $100 million premoney valuation, but ought to be comforted by the fact that Facebook is valued at $50 billion and the numbers keep getting higher. Accel's investment has grown at

least 50x in six years—not too shabby, eh?

Chapter 10

Structuring Investment Transactions

> For many entrepreneurs, reading a term sheet is no more interesting than reading the latest volume of the Federal Register.
>
> And most lawyers will tell you what the terms mean but not how they can be used to screw you, how to negotiate them, and what is the "norm."
>
> *—Mark Suster, General Partner, GRP Partners*[1]

Much has been written about term sheets, including line-by-line analysis of terms. A line-by-line analysis is helpful, but it is akin to looking at trees when the perspective of the complete picture or the forest is critical. My own struggle with term sheets was the legalese: the jargon that was a completely different language. Newbie practitioners describe standard term sheets as "incredibly dense" and often hesitate to tackle these. The goal of this chapter is to simplify, prioritize, and focus on the key terms that help complete a transaction. Investment structure is the framework that describes the flow of capital from the investor to the company and back.

THE SPIRIT OF THE TERM SHEET

After due diligence, investors propose a set of investment terms

that define the transaction. At the heart of it, both the entrepreneurs and investors agree upon the following underlying spirit of the term sheet:

- The investment opportunity and market conditions are ripe for rapid growth.
- Both parties bring a unique set of elements—technology and capital—to create value.
- Together, these elements can help catalyze and create value faster.
- Both parties agree to collaborate for a meaningful period of time, ideally until exit do us part.
- Both parties understand that financial success is critical for both parties, as is the timing of returns.

While this credo can be established, there can be several points of creative tension or stress between the two parties.

NEGOTIATION STRESS POINTS

The potential stress points in any negotiation can occur around the economic or control factors. Table 10.1 identifies these stress points and the relevant terms that address them.

Table 10.1 Differing Goals of Entrepreneur and Investor

	Entrepreneurs Want . . .	Venture Capitalists Want . . .	Relevant Terms That Come into Play
At point of entry	Maximize valuation	Minimize risk and valuation; potential for up rounds and target returns	Price per share and amount of investment leading to valuation
	Adequate capital to meet and exceed milestones	Capital efficiency; reach breakeven/financial independence rapidly	Amount of investment, use of proceeds
	Avoid loss of control	Ensure that the team, strategy, and vision are aligned	Employment agreements, vesting of founders' stock, structure of board, independent board seat choices
Between entry and exit	Venture capitalists bring strategic value, domain expertise, and connections	Ensure that execution is as agreed on and that business strategy and plans are sound	Board and governance matters; milestone-based financing
	Venture capitalists can help with future financing	If opportunity grows rapidly, maintain pro rata ownership	Preemptive rights or right of first refusal
	Stay in control and experiment despite inefficiencies	If it doesn't grow as well and leads to the "living dead" category, have the ability to liquidate	Antidilution, redemption, or liquidation, drag-along rights and tag-along rights
Exit	Can be patient; may choose to delay/avoid an exit	Speed to exit is critical	Redemption, dividends, liquidation preferences, and registration rights
Exit Drivers	Self-actualization	Highest IRR	

Types of investment structures include debt, convertible loan, and preferred stock. A simplest form of investment, a debt would be governed by some basic parameters, such as the principle, interest rate, collateral, and schedule of payments. Debt may be secured by collateral such as assets and/or receivables, or it may be unsecured. An unsecured debt acts as a quasi-security. In this chapter, convertible note and preferred stock structures are presented. The preferred stock is the most commonly used investment structure in venture capital investments.

But at the heart of it, investment structures are designed with two key parameters: economics and control. As Brad Feld of the Foundry Group points out, terms sheets can be simple if we focus on what matters:

> **1.** *Ownership and economics:* Buying a meaningful slice of the company at the right price is the first step for any investor. But most savvy practitioners know that while valuation is important, the potential of the opportunity in the long run, as well as other investment terms, matters. In some investments, such as distressed real estate, the philosophy that "you make money when you buy" may be true; with VC investments, that may not necessarily be the case. A premoney value of $8 million or $10 million is not that significant when the opportunity could potentially offer a billion-dollar exit. The price-based debate creates undue tension at the point when a relationship is being established.
>
> **2.** *Governance and control:* Also described as protection or control aspects of an investment, these

rights minimize risks, protect against any downside, and thereby potentially amplify the upside. Governance is established by the board of directors, which typically appoints the CEO and approves an annual plan, budget, and major business decisions. The board is controlled by investors and establishes certain protective provisions to ensure that the management does not jeopardize the security interests of the investors.

Let us start with the convertible loan, a simple investment structure that is used more often by angel investors and early-stage investors.

Convertible Loan

A convertible loan starts with senior position on the balance sheet and drops down, or converts to equity, when the company meets certain milestones. Primarily used as a risk mitigation tactic in the early stages of the company, a convertible note allows the investor to claim the assets of a start-up if it fails. Alternatively, in certain conditions, the note holder can call the note. Used in situations where establishing valuation is cumbersome, a convertible note postpones the pricing of equity until a suitable event occurs. The key parameters that come into effect with convertible notes are principle, interest rate, and conversion trigger points. After the conversion, the interest payments are terminated and appropriate changes on the balance sheet (the liabilities are shifted to the equity section) are duly recorded. Typical convertible note terms include:

- *Interest rate*: Depending on the risk investor's appetite, interest rates vary from 3 percent upward to as much as 10 percent; it is normal to accrue interest for most convertible notes.

- *Term*: Typical terms are one year, but notes can be as much as two years or higher.

- *Conversion triggers*: The note would convert to preferred stock upon raising a predetermined amount in a Series A round.

- Improving the returns: Investors frequently add a few other aspects in the mix to improve the risk-reward ratio.

    - *Discounts*: For example, a 20 percent discount to the share price established at following series.

    - *Warrants*: Warrants would act as sweeteners and help aggregate a higher ownership via additional shares at a lower price point.

- Capped valuations: A capped convertible note establishes a cap on valuation for the next round; for example, a cap at $2.5 million premoney indirectly establishes the valuation of $2.5 million at the next round. Mark Suster

> warns, “Make no mistake—this IS a priced round.” A sword that can cut both ways, a convertible note with cap, could hurt the entrepreneur, he points out. “It basically sets your maximum price rather than your actual price. Example: If you do a convertible note raising $400k at a $3.6m premoney, your ceiling is that you've given away 10 percent of the company ($400k/$4m postmoney). But your actual next round might come in at $2 million premoney. You might have been better just negotiating an agreed price in the first place. Not always, but sometimes.”[2]

For angels and early-stage investors and entrepreneurs, the valuation debate can be postponed by using a convertible note. Generally speaking, savvy investors resist any structure where the value is to be ascertained by a third party at some point in the future. Entrepreneurs find the convertible note easier to digest as the valuation can be built to their advantage, speedier to negotiate, with limited legal expenses.

JUST DON'T F— IT UP …

Peter Thiel, an investor who made his money in PayPal, was one of the first angel investors in Facebook. He invested $500,000 as a loan that would convert to equity if Facebook achieved its milestone of 1.5 million users. “Just don't f— it up,” Thiel said to Mark Zuckerberg at the time of investing.

Facebook did not meet the milestone, but Thiel converted his loan to equity and joined the board. Thiel's $500,000 got him 10.2 percent equity, implying a valuation of $4.9 million for the company. In six years, Facebook's value has grown to an estimated $50 billion. Thiel's investment has grown by a mere 10,000x in six years!

Source: David Kirkpatrick, The Facebook Effect (New York: Simon & Schuster, 2010), page 89.

Bridge Loan

Similar to a convertible note, a bridge note is raised to meet certain short-term needs of a company. Typically used between financing rounds, a bridge loan bridges a company between its existing cash and a future financing round. Terms are similar to a convertible note. Investors are leery of a bridge to nowhere and may build in a stair-stepped interest rate, warrants, or incentives. Thus, if the bridging event does not occur as predicted, investors gain additional ownership as a result.

Table 10.2 Summary of Key Investment Terms: Preferred Stock

Term	What It Means	Importance to Investors	Key Negotiation Variables
Economic Terms: Those That Impact Financial Outcomes for Investors			
Valuation	Establishes value of a company	Project potential IRR	Percentage of ownership, price per share
Liquidation preference	Creates a waterfall of distribution—who gets paid first and how much—when a liquidity event occurs.	Improves returns at exit, protects investment at lower exit values	Multiple (1x, 2x), participating preferred, cap/no-cap
Antidilution	Prevents dilution of investors' ownership when down rounds occur.	Minimizes downside/protects ownership	Weighted average/full ratchet
Dividends	Allows investors to declare dividends	Improves potential returns	Percentage, cumulative/ noncumulative
Preemptive rights/right of first refusal (ROFR)	Allows investors to buy additional shares in future rounds	Allows for increasing ownership if opportunity gets stronger	Time frame for decision, pro rata share
Redemption of shares	Allows investors to redeem their ownership/shares after certain time frame. Ensures that investors are able to	Allows for exits; redemption is especially important when the company has minimal upside potential.	Time period (number of years), fair market value.
Registration rights, conversion to common at public offering, piggyback rights, drag-along rights/tag-along rights, co-sale agreements	trigger the timing and conditions of an exit; drag-along and tag-along rights allow one party to sell his or her shares if the other party is able to find a seller.	Registration rights depend on the strength of the company and state of the public markets.	These are exit-related provisions and savvy practitioners do not waste much time negotiating these boilerplate terms.

Governance Terms: Those That Impact Control of the Company

Board composition	Number of seats for Series A, common, and independent shareholders	Allows for control and protection of security	Number of seats, how the board structure can be changed, rights of preferred shareholders vis-à-vis the rest
Board approval items	Board approves hiring of executives, employment and compensation agreements, issuance of stock options, annual operating plan, and incurrence of debt obligations or contracts above a certain financial limit	To protect the ownership and equity, board would approve key business decisions that may impact the operations or the equity structure of the company.	David Cowan of Bessemer Venture Partners says, "As long as the ink is black—if the company is doing fine—I don't care much about control provisions."*
Protective provisions	Allows for protection of security interests	Preferred shareholders will approve all changes to securities, board structure, mergers, redemption of stock, and amendments to articles of incorporation	Most of these terms are standard and very few practitioners open these up for negotiation.
Employment and vesting for management	Keeps management team focused on building the business	Aligns interests of founders and investors	Employment agreements, stock vesting, restrictions on co-sale, creation of option pool, key man insurance, noncompete provisions

*David Cowan (Bessemer Venture Partners), in discussions with the author, December 2010.

Equity: Preferred Stock

In Chapter 8, we discussed preferred stock and how this class of shares enjoys control and financial preferences over and above the common shareholders. Table 10.2, summarizes these various aspects of a term sheet. If the value of preferred stock grows, the ability to invest additional amounts of capital, such as with preemptive rights, helps investors maintain or build their position in a growing company. If it sours, the ability to gain control (via management changes), minimize the impact of downsides (via antidilution), and attempt to salvage the remains of the day is important. In reality, most practitioners agree that if any opportunity teeters, not much can be done to resurrect the remains. In any portfolio, at least a third of the investments will likely end up as write-offs.

Warrants

A warrant is a right to buy a security at a fixed price: the "exercise" or "strike" price. Typically, warrants are issued in conjunction with an existing investment—a security, such as a convertible note or venture debt. For investors, warrants provide the ability to increase the overall return. Investors can improve their ownership positions at a suitable point in the future, as the opportunity matures.

A typical warrant would include terms such as:

- Percentage of investment or amount of investment:

- Percentage of investment: If an investor issues a $500,000 convertible note with 10 percent warrants, the warrant allows the investor to invest $50,000 in the future.
- Amount of investment: The warrant allows an investor to purchase shares worth $100,000.

- Strike price:
  - Nominal value: Established at, say, $0.001 per share. An investor-friendly term, this would allow an investor to increase ownership at a certain point in the future.
  - Share price of the next round: A company-friendly term, this allows an investor to double up or increase the ownership position.

- Term:
  - Time: Term could be any time, say, up to 10 years; the longer the duration, the better for the investors.
  - Event-based triggers: Reduce the life of the

warrant upon certain trigger conditions, such as future financing or value creation milestones. Such milestones reduce the overall liquidity that would affect the founders.

Springing Warrants

At the point of entry, valuation debates are the primary cause of tension. Founders believe that the value of the company should be as high as possible. Its technological marvel—future revenue and growth projections are just a matter of time. For practitioners who have heard ample stories and burnt their capital, the skepticism is obvious.

For John Neis of Venture Investors, the answer was simple—the middle path. When the founders of Tomo Therapies came up to discuss an investment opportunity, Neis was intrigued, but like most practitioners, he looked at the financial projections with a degree of healthy skepticism. Typically, the struggle between the buyer and the seller is evident, as each side tries to extract the maximum value up front. Not in this case—Neis developed a structure of springing warrants.

In this structure, quite simply, the venture fund's ownership decreases as the founders and entrepreneurs meet their projections and milestones. A representative example is presented in Table 10.3. It is an elegant model to balance the ownership struggles and

provide adequate rewards if the founders meet their goals. The springing warrants are issued to founders and these are exercisable (at a nominal exercise price) at certain milestones. The founders would thus acquire additional shares of common stock based on a predetermined formula. In the example in Table 10.3, if the founders believe they can generate revenues of $30 million in 2014, while the investors think it would be more like $23 million, the two parties can converge the valuation today with the assurance that as founders create value, investors relinquish a portion of their equity.

Table 10.3 Springing Warrants Can Be an Effective Way to Diffusive Valuation and Performance-Related Challenges

Revenues	2012		2013		2014	
Baseline Revenues	$5M		$12M		$23M	
Upside case revenues	$7M	$9M	$15M	$18M	$27M	$30M
Additional equity granted to founder for meeting upside targets	3%	5%	3%	5%	3%	5%

Tomo Therapies (Nasdaq: TOMO) grew to $200 million in revenues in four years of commercial launch. For Neis and Venture Investors, the largest shareholders, this investment was a barn burner—a 10x return or higher. As a result, Neis was listed in the Forbes Midas list, the first Midwesterner to be featured in this coveted club of who's who of successful venture capitalists. In his modest style, he says, “Tomo's technology saves lives—and bringing that to market was the important goal for all. The financial returns are always a welcome by-product of our efforts to change the world.”

Options

The typical recipient of a stock option is an employee. A typical recipient of a warrant is an investor. This is the primary difference beyond which the mechanics are more or less the same. It is important for any practitioner to understand the impact of an option pool on the investment structure. When exercised, options will dilute ownership for all stockholders. Employee stock options are offered as incentive tools to attract and retain talent. Incentive stock options are used for vendors, consultants, and the like. The tax implications for each need to be considered—these are beyond the scope of this book. Typical option agreements include:

- Number of shares
- Strike price
- Term and vesting
- Buyback provisions

MILESTONE-BASED FINANCING: RISK MITIGATION OR DISTRACTION

Staged financing is used in seed and early-stage investments, and the primary reason is to de-risk the opportunity. Completion of a prototype and customer validations are a few examples of milestones that are typically used to structure investments. Recall

Peter Thiel, who agreed to invest in Facebook with the precondition that his note would convert to equity after they reached a certain number of users. Staged financings can provide incentive for the teams to perform and move faster, and entrepreneurs can be assured that the tranches of capital will arrive as the milestones are completed. But is it that simple?

"Milestone-based financing forces the management to either declare victory too soon, or worse, it distracts them from a potentially bigger opportunity—in an evolutionary stage, milestones can push the founders in the wrong direction," says Jack Ahrens of TGap Ventures. If you choose to use milestone-based financing, consider the primary question: "Can you disengage if the milestones are not met?"

Further, the caveats are:

- *Definition of milestone:* Avoid ambiguity and insist on measurable and simple definitions. Instead of a broad, complete beta, it would be prudent to identify the top three key functions that the technology should meet.

- *Amount necessary to reach milestone:* If an entrepreneur prepares the budget, a practitioner needs to ensure that the resources, amounts, and line items are vetted. On the flip side, if you squeeze the amount down, be prepared to accept the blame: A common excuse from entrepreneurs can be "We couldn't meet the milestones because we did not have enough money to start with."

As with most terms, flexibility, speed, and simplicity are the keys to a successful start.

STRUCTURING TERMS TO GENERATE TARGET RETURNS

A good investment structure allows an investor to double up and invest higher amounts as the opportunity progresses—or minimize the risks if it craters. Structure starts with valuation primarily, followed by liquidation and antidilution preferences (used to protect ownership), dividends, and rights of first refusal. These terms combined effectively can help any investor (a) establish an ownership position and (b) build up ownership as the opportunity progresses.

Liquidation Preference

The second most important term after valuation is liquidation preference, writes Mark Suster of GRP Ventures.[3]

Liquidation preferences, often seen as an opportunity to juice up the returns, are rights to receive a return prior to common shareholders. These preferences come into play at the time of liquidating the assets of the company. Liquidation occurs under two scenarios: a sale via acquisition (presumably a good outcome if the sale price is right) or shutting down the company (and calling it a dog).

From a negotiation perspective, liquidation preferences have the following variables:

- *Liquidation multiple:* Defined as multiple of the amount invested, practitioners set a multiple of, say, one time the value of the original investment. This essentially translates to investors recovering the amount invested. The multiple is an indicator of market dynamics, and while one time is the standard norm in a healthy market, at times the multiple has scaled up to as much as 10 times. In the third quarter of 2010, 85 percent of the transactions had a multiple of one to two times.

- *Straight convertible preferred or nonparticipating:* In a non-participating liquidation preference, investors are entitled to the amount they invested and dividends, if any. That is it: They do not get anything more. Under certain circumstances where an earn-out amount has been offered upon achieving certain milestones, investors can get a higher return when the preferred shares are converted to common. Thus, practitioners should ensure they have the option to choose the greater of the two scenarios.

- *Participating preferred (or, as entrepreneurs call it, a double dip):* In this scenario, investors first recover the amount invested, dividends, and the multiple agreed on. The double dip occurs when they participate—a much kinder term—which means the preferred shareholders get to enjoy the spoils with the common shareholders on an as-converted basis. Market trends indicate that about

50 percent of the transactions conducted fall in this category.

- *Capped participation:* A smart entrepreneur may have invented this term, which essentially caps the return any investor can get. A typical cap would be, say, 2.5x of the original amount invested. Typically, about 40 percent of participating transactions are capped.

A s Table 10.4 illustrates, liquidation preferences can have a significant impact on the rate of return. But it is primarily a downside protection mechanism for investors. At larger exit values, these preferences do not demonstrate a significant impact on the common shareholders or the IRR.

Table 10.4 Liquidation Preference and Its Impact on IRR and Common Shareholders

	4x	2.5x No Cap	2.5x Capped	1x
Liquidation Multiple (A)	$3,600,000	$2,250,000	$2,250,000	$900,000
Dividends (B)	216,000	216,000	216,000	216,000
Balance (C = A − B)	184,000	1,534,000	1,534,000	2,884,000
As Common (D = 47% of C)	86,480	726,631	726,631	1,366,105
Total to Investors (A + B + D) =	3,902,480	3,192,631	2,250,000	2,482,105
IRR to Investors	63%	52%	36%	40%
Balance for common shareholders	$97,520	$807,369	$1,750,000	$1,517,895

Assumptions:

- Acquisition value for company = $4 million
- Investment = $900,000
- Time to exit after initial investment = 3 years
- Dividends at 8 percent per annum, noncumulative

Stacking of Liquidation Preferences over Multiple Rounds

If you are a Series A investor and a Series B investor arrives and stacks on his or her preferences on top of yours, the scenario could get more complex due to the misalignment of interests between the various parties (two separate classes of preferred shareholders and common shareholders). Brad Feld of the Foundry Group writes in his blog:

> As with many VC-related issues, the approach to liquidation preferences among multiple series of stock varies (and is often overly complex for no apparent reason). There are two primary approaches: (1) The follow-on investors will stack their preferences on top of each other: series B gets its preference first, then series A or (2) The series are equivalent in status (called *pari passu*…) so that series A and B share pro-ratably until the preferences are returned. Determining which approach to use is a black art which is influenced by the relative negotiating power of the investors involved,

ability of the company to go elsewhere for additional financing, economic dynamics of the existing capital structure, and the phase of the moon.[4]

Higher Liquidation Preferences = Demotivated Founders and Employees

Excessive liquidation preferences benefit only the investors and reduce the potential outcomes for common shareholders, including management and founders. When those who are working hard to create value see that all they would get is W-2-like returns, the desire to perform and create significant value diminishes. Brad Feld explains: "The greater the liquidation preference ahead of management and employees, the lower the potential value of the management/employee equity. There's a fine balance here and each case is situation specific, but a rational investor will want a combination of 'the best price' while insuring 'maximum motivation' of management and employees. Obviously what happens in the end is a negotiation and depends on the stage of the company, bargaining strength, and existing capital structure, but in general most companies and their investors will reach a reasonable compromise regarding these provisions."[5]

An elegant solution to protect the founders could be the founder's liquidity preference. Although rarely used, it is a creative approach to address the challenges wherein the founders can washed out completely. "Creating a special class of common stock for the founders with a special liquidation preference is not typical, but it is an option that offers investors a great deal of flexibility and creativity," writes attorney Jonathan Gworek. Gworek recommends a win-win approach where a founder's

liquidity preference creates a financial threshold for the founders, especially if they have invested significant capital prior to any outside investments. Such a clause allows for the founders to retain a floor, a minimum position for value created by the entrepreneurs.[6]

Professors Colin Blaydon and Fred Wainwright, who head the Center for Private Equity and Entrepreneurship at the Tuck School of Business at Dartmouth, write that "risk-reducing mechanisms were seen to be counterproductive—an attempt to 'close the barn door after the horse was gone.' " Blaydon and Wainwright conclude, "the continued prevalence of a participation feature in deal structures today indicates that the VC community either has less confidence in the potential growth of portfolio companies or a lower appetite for risk." Further, they point out that participation "sets a precedent for terms in subsequent financing rounds" and that the "VCs who funded the earlier rounds … will now have to transfer some of that hard won value to the new investors."[7] It becomes a karma thing, as a Series A investor tries to squeeze the entrepreneur; when the Series B investors come in, they love to jump in and do the same. Ahrens of TGap Ventures says, "It is best to avoid any multiple preferences and clever terms—it becomes a rat's nest and does not do anybody any good." At the early stage of investment, simpler is better. "You are betting on the market and the CEO—let's not get too tied up in preferences and such legalese when there are no revenues and no product," says Rick Heitzmann, FirstMark Capital.[8]

Consider the typical trends of liquidation preferences.

- In 2010, an average of 40 percent of financing uses senior liquidation preferences. As the series scale up to Series C and D, senior liquidation preferences grow, from 30 percent (at Series B) to 60 percent (at Series E or higher). Naturally, the later investors are risk-averse and want to have the exit prior to the other investors, and thus demand better preferences.

- At least 20 percent of the financings have multiple liquidation preferences. As much as 85 percent of the Series A financings have a multiple of 1x to 2x, with the rest being 2x to 5x. In certain market conditions, when capital supply shrinks, or if the company may have struggled, a 5x preference was observed.
  At Series A, about 50 percent of financings were participating preferred. Of these, about 25 percent to 50 percent had no cap. The rest were capped anywhere from 2x to 5x.

Antidilution Protections

Antidilution protection is a downside protection mechanism that protects existing investors when a company is forced to accept a down round, which is a lower share price compared to what the previous investors have paid. Existing investors receive additional shares, and their position is adjusted based on the price of the down round. The common shareholders, typically the management and founders, endure the maximum pain in such circumstances. An investor-friendly term, it forces the

management team to retain value, execute on its milestones, and ensure value is created in an effective and timely manner. However, down rounds can occur with changes in burn rates (as unanticipated issues occur). Poor market conditions could significantly affect a company's ability to raise future rounds of capital.

Antidilution provisions fall into three categories:

1. *Full ratchet*: An investor-friendly provision, this has the largest impact on the common shareholders. The full ratchet converts the price of *all* the previously sold shares down to the price of the current round irrespective of the amount raised or the number of shares issued.

2. *Broad-based weighted average:* A company-friendly provision (well, a true company-friendly provision = no antidilution provisions), this clause has the least impact of all on common shareholders as it is based on the weighted average of the outstanding shares, including options and warrants.

3. *Narrow-based weighted average*: Same as broad-based, but eliminates the options and warrants and thus has a lower impact on common shareholders.

The norm is weighted average (either broad-based or narrow-based), and thus practitioners are better off staying in the middle of the road.

As Table 10.5 illustrates, the impact of antidilution on Series A

would have been significant if there were no protective provisions. This is illustrated in the line "Additional ownership due to antidilution protection." The full ratchet offers maximum additional ownership, while the weighted average drops the ownership proportionally. Notice the significant drop in ownership for common shareholders.

Assumptions:

Series A price per share = $9

Number of Series A shares sold = 100,000

Series A amount raised = $900,000

Series B price per share = $4.50

Number of Series B shares sold = 250,000

Series B amount raised = $1,125,000

Frank Demmler, who has participated in over 200 investments, points out that if Series A antidilution leaves little ownership for common/management, the Series B investors will have a due concern. Often, Series B investors will drive renegotiation between Series A and management to find a satisfactory middle ground. "The bottom line is that under most circumstances, full ratchet antidilution protection will be completely waived, while weighted average is likely to be accepted."[9]

So why negotiate for something that will potentially be renegotiated anyway? In 2010, over 93 percent of the financing

rounds used weighted average antidilution.[10] These percentages vary slightly as capital supply and demand conditions vary. Advice to rookie practitioner: stick with weighted average antidilution.

Dividends

While most early-stage practitioners know that dividends are neither expected nor declared by the board, the provision is included in the term sheet. The investor-friendly language is to seek cumulative dividends to juice up returns at the time of an exit. The 2010 data trends indicate that about 40 percent of Series A financings seek cumulative dividends. In 2005, as much as 80 percent of Series A financings sought cumulative dividends.

As we can see in Table 10.6, liquidation preferences, combined with the antidilution provisions, impact the overall economics significantly.

Table 10.5 Impact of Antidilution Provisions on Ownership

		Full Ratchet (%)	Weighted Average—Broad (%)
	Series A	Series B	
Series B Preferred		42.6	44.5
Series A Preferred	47	17	17.8
Additional Ownership Due to Antidilution Protection		17	13.2
Common	43	18.9	19.8
Options	10	4.4	4.6

Table 10.6 Key Economic Terms and the Middle Path

Economics	Investor Friendly	Middle of the Road	Company Friendly
Liquidation preferences	2x or higher, no cap, participating preferred	1x participating preferred	No liquidation preferences
Antidilution preferences	Full ratchet	Weighted average—broad	No antidilution preferences or weighted average—narrow
Dividends (as and when declared by the board)	12% cumulative	8% noncumulative, as and when declared	None

Source: Adapted from Alex Wilmerding, *Term Sheets & Valuations: An Inside Look at the Intricacies of Term Sheets & Valuations* (Boston: Aspatore Books, 2003).

Pay-to-Play

Usually, this clause comes into effect when several investors have joined the club, say at Series B, Series C or later. The provision tries to keep the syndicate together and ensure that all investors continue to participate in future rounds, especially when times are bad. As venture funds of varying shapes, sizes, and motivations join the syndicate, it is likely that Fund A will not have as much ammunition as Fund B. Or views of Fund A may differ with Fund B on the company's exit potential, execution plan, or business strategy. The pay-to-play provision would mean that if Fund A is unable to invest more capital in the following rounds for any reason, it will no longer play. Fund A gets kicked out of the playground wherein its ownership is converted to common stock, resulting in the loss of preferences and any substantial economic upside.

Preemptive Rights/Right of First Refusal

Seed and early-stage investors seek a right of first refusal (ROFR) to ensure that they can maximize their upside. Thus, when a company is ready to offer additional securities, the first call would be placed to existing shareholders. In some situations, ROFR allows investors to purchase any founders stock that may be up for sale. This tactic is used by early-stage investors who place a smaller amount of capital and as the opportunity matures, they are able to increase their ownership and take advantage of the potential upside.

GOVERNANCE AND CONTROL: PROTECTING YOUR SECURITIES

All governance and control aspects in any term sheet are designed to protect the ownership interests of investors. Security ownership can be challenged due to internal performance issues (poor performance leads to cash challenges or lower valuation) or external financings (down rounds, debt obligations). An investor attempts to manage these conditions by controlling the board, via governance and control mechanisms.

Consider the Series A investor in NewCo, who owns a 47 percent interest and thus is a minority ownership from a control perspective. But special voting rights and preferences allow such an investor to exercise control over key aspects of the company. As described in Table 10.2, typical board approval items include:

- *Officers and management hiring, firing, and compensation*: These provisions allow the board to select the CEO, and if necessary replace him or her if

performance is lax.

- *Stock option programs*: These have a dilutive impact on the overall shareholders if an option pool is not established. Establishing an option pool may require shareholder approval. If an option pool is established, the board would approve grant of options to key executives.

- *Annual budgets*: As the annual budgets are directly related to the direction of the company and spend rates, the board typically approves all major budget items.

- *Debt obligations*: Any secured debt creates a lien on assets of a company, and can be a drain on the cash. Under the right circumstances of growth, venture-backed companies raise debt. The board would approve any debt obligations to ensure they are aligned with the CEO/CFO's plans and performance.

Protective provisions included in the term sheet would minimize any impact to the value or preferences of the security:

- *Ownership/shares*: Any issuance of stock would impact the ownership, and dilute current owners. Furthermore, the pricing of stock, the amount being raised, and the type of investors are all approved by existing

investors/board members.

- *Mergers/acquisitions and co-sale*: Investors and all shareholders would approve such moves, as these impact ownership and economics.

- *Changes to the certificate of incorporation, voting, and bylaws*: Any changes in the corporate structure are typically approved by all shareholders and can impact the powers of the board.

- *Changes to board or election procedures*: Existing board members typically approve any changes to the board structure (additions of seats, observers) that occur as newer investors come to the table. Investors control the board dynamics closely, especially in the early stages of the development and growth.

EXIT-RELATED PROVISIONS

These provisions come into effect at the time of the sale of the company. As very few companies go public, savvy investors do not invest too much time and effort splitting hairs around these terms. For the most part, these are treated as boilerplate language. A brief description of the terms follows.

Redemption

Certain practitioners are tempted to sell the stock back to the company and redeem their investment at, say, the sixth anniversary. This provision is typically triggered when the company has made modest middle-of-the-road progress, but is not going to be a significant exit for investors. Unkind expressions address these as the living dead. This provision implies that the investment is more a debtlike instrument and attempts to recover some or all of the investment.

Drag-Along Rights/Tag-Along Rights and Co-Sale Agreements

These rights allow investors to "drag" the shareholders to an exit. The dragging comes in when a specified percentage of shareholders wants to sell the company when another group, typically, the founders or common shareholders, refuses to sell. The price may not be right, or they may see a bigger, better opportunity in the future. The investors may have given up on the opportunity and choose to get what they can. Drag-along provisions allow investors to sell the package as a whole—if any investor is unwilling to sell, it could block an exit, and this provision allows the sale to occur. In tag-along provisions, also called co-sale agreements, the founders or management either give up or find a third party to whom they can sell their shares. The tag-along rights allow investors to tag along with the founders and offer their shares for sale as well.

Conversion to Common at Public Offering, Registration Rights, and Piggyback Rights

In the rare event a portfolio company is ready to file for an IPO,

all securities convert to one class: common stock. This allows for smoother marketing and share price establishment. Thus, the preferences established will vanish. In *Venture Capital Due Diligence*, Justin Camp writes, "Convertible instruments allow investors to take full advantage of the protections offered by preferred stock … until they are no longer necessary, and then allow them to forgo such protections. When investors invoke registration rights, they push the company to register the stock or piggyback on other registrations. Once registered, venture capitalists are able to sell their stock in the public markets."[11] Investors can demand registration, although several factors come into play, primarily the revenues, growth rate, and state of the public markets. Piggyback rights obligate companies to let investors piggyback on the registration.

OTHER TERMS

These terms fall neither in the economic nor the governance category but are important to align the interest of investors and management.

Employment-Related Terms

All founders and key management team members should execute employment agreements. Other important terms such as stock vesting, restrictions on co-sale, key man insurance, and noncompete provisions are included to ensure management teams are aligned with the long-term goal of value creation.

Employment agreements clearly state a founder or manager's roles, responsibilities, and deliverables. These agreements

incentivize the team to stay with the company, especially through tough times, and to create value. Stock vesting for founders is often negotiated aggressively to ensure that after the investment is made, the founders remain and continue to add value to the company. A separate "Stock Option Plan" is typically created postinvestment and governed under the auspices of the board. This plan determines the dynamics of the employee stock options. Should an employee be terminated, his or her ability to exercise the balance of options will lapse.

THAT WAS ONE EXPENSIVE PARTY …

Sean Parker, one of the founding board members of Facebook, was arrested and charged with cocaine possession. He was pushed out of Facebook and lost his unvested stock options. These lost options would grow to approximately $500 million in value over a four-year span.

Source: David Kirkpatrick, The Facebook Effect: The Inside Story of the Company That Is Connecting the World (New York: Simon & Schuster, 2010), 146–148.

Vesting can occur on a quarterly basis over a three- to four-year period. Acceleration of vesting upon acquisition is considered suitable to reward management for having created value. The contention is amplified when founders quit or are fired: The vesting debate can create a fair amount of distraction and hence needs to be addressed in employment agreements.

The restrictions on co-sale have been seen in a new light, especially when founders are allowed to take significant portions of their stock and liquidate them prior to a sale or IPO. Key man provisions are methods of ensuring that investors are protected if

key management team members were to become unavailable due to death or disability.[12] Noncompete provisions can be enforced in certain states, but not all. The duration (number of years) and scope (geography, sector) of the noncompete needs to be negotiated diligently.

Closing Conditions

The following miscellaneous conditions are prescribed in the term sheets:

- *Exclusivity and no-shop clause:* To ensure entrepreneurs do not use the opportunity to get an auction going or to find better terms of investment by "shopping" the term sheet around.

- *Closing date and conditions:* To ensure that all parties, legal counsel for both sides especially, are prepared to complete the transaction on a certain date and meet any conditions prior to closing

- *Nondisclosure, press/media:* To ensure confidentiality until the parties are ready to make any announcements

TOWARD A SIMPLER TERM SHEET FOR SMALLER INVESTMENTS

When Silicon Valley lawyer Ted Wang decided to simplify the standard hundred-page term sheet, he started with Mahatma Gandhi's quote: “First they ignore you. Then they laugh at you. Then they fight you. Then you win.” Three years later, when Mark Andreessen adopted Wang's simplified term sheet, the victory was clear. In his uncommonly modest style, Wang wrote, “I hesitate to use a quote from one of the greatest people ever to grace planet earth, and certainly the question of how to structure early-stage investment is a laughable cause as compared to the rights that Gandhi (also a lawyer) fought to advance. That said, I think this quote accurately captures the life-cycle of creating a simple set of documents for early-stage investment.”[13]

The motivation: “Start-up company lawyers are under an intense pressure to keep our fees low on these deals and we find ourselves struggling to meet our clients’ expectations around pricing,” wrote Wang, who represents companies like Facebook, Dropbox, and Twitter.[14] “The result is that these small Series A deals have become a source of unwanted tension between us and our clients.”[15]

Wang's simplified documents are relevant to the seed stage investors as well as succinct. And he may have had a lot of unlearning to do, as he eliminated language that had been a part of term sheets for 20 to 30 years. The simplified term sheet, about 30 pages in all, eliminates antidilution, registration rights, and closing conditions. Even more so, it reduces the time and expenses for completing the investments.

“The big reason we are doing it is that we think for these early-stage round, bashing over these terms does damage only brings

mistrust," Mark Andreessen was quoted as saying. "VCs who do angel rounds should be acting like a VC in a VC round and acting like an angel in an angel round. The problems come when VCs act like VCs in angel rounds."[16]

Separately, the law offices of Wilson Sonsini have developed an online tool that generates a venture financing term sheet based on inputs/responses to an online questionnaire. Fifty years ago, in 1954, Roald Dahl, popular writer of children's fiction, wrote a short story, "The Great Automatic Grammatizator"—in which a mechanically minded man concludes that the rules of grammar follow mathematical principles. He creates a mammoth grammatizator—a machine that can write a prize-winning novel in 15 minutes. Wilson Sonsini has developed such an engine, a term-sheetizator if you will, that takes a few inputs and develops fascinating term sheets. The WSGR term sheet generator has an informational component, with basic tutorials and annotations on financing terms. This term sheet generator is a modified version of a tool that the firm uses internally, which comprises document automation tools that the firm uses to generate start-up and venture financing-related documents. Because it has been designed as a generic tool that takes into account a number of options, this version of the term sheet generator is fairly expansive and includes significantly more detail than would likely be found in a customized application. Worth a look—see www.wsgr.com/wsgr/display.aspx?sectionname=practice/termsheet.htm.

SYNDICATING INVESTMENTS

An analysis of over 2,000 venture transactions shows that

syndication was found to be highest in biotechnology investments (in over 60 percent of investments) and lowest in the software sector (with only 37 percent of investments). Syndication was least at the seed stages and increased in later stages.[17] Risk does bring investors together, especially in biotech sectors where capital intensity is significant.

Whether seeking syndicate investors or being asked to be one, the simple rule applies: Does the combined intellectual and financial acumen allow for the better outcomes of the investment opportunity? When inviting syndicate investors into opportunities led by Walden International, Lip-Bu Tan follows a blended approach of the heart and the head: "I look for complementary skill sets in syndicate investors so that the combined power of the board is higher in terms of value add. I am also very picky, so the core philosophy of building a company for the long term rather than the short term is important. Mutual respect is important, as is the willingness to come up with a solution that is best for the company. No ego trips!" Tom Perkins, while seeking the first round of funding for Tandem Computer, wrote about his experiences: "I showed our business plan, which I had mostly written myself, to all the local potential investors with no luck. … The investors' rejection was based solely on general worries over the companies in the field. … They had little understanding of the technical breakthrough we had achieved and how difficult it would be for those competitors to duplicate our effort and circumvent our patents. … These were financiers … who maybe were clever with money but who had no … confidence in technology, the kind of investors who relied on hired experts to tell them what to think."[18]

Practitioners need to conduct due diligence on each other with the same rigor they would apply to looking at new opportunities, but add a few other parameters to the mix: What are the motives of the syndicate investor? Is it a true partnership? Are their interests aligned? Do they have the ability to withstand the tremors?

Ideally, smaller funds would invite larger funds to participate with the optimistic outlook that as the capital needs for the company grow, the larger funds will be able to lead the future rounds. If a small fund invites a larger fund to come in as a syndicate partner, it creates a win-win situation for both funds. A smaller fund generates the opportunity and acts as a feeder to the larger fund. In turn, the larger fund can invest substantially higher amounts as needed by the company. The smaller fund needs to consider how anti-dilution and pay-to-play provisions could affect the smaller fund if the opportunity does not progress as desired. The loss appetite also differs with the size and the stage of the fund.

"It took me 15 years to crack into the inner circle of the Silicon Valley venture network. To be invited to co-invest in opportunities with the likes of John Doerr, Promod Haque, and other established practitioners takes time—you have to earn their respect as a value-add partner," says Tan.

Syndication caveats include choosing your partners with care. As one practitioner pointed out, "keeping a bad venture capitalist is worse than the first time bad entrepreneur."[19] Syndicate with the ones you trust—you know how they will react in bad situations.

Partnership of unequals can be challenging. As a practitioner remarked, “I would hope that we would get an equal ownership, but if Sequoia says they want 75 percent and we keep 25 percent, we'd be happy with that.”[20]

THE CLOSING PROCESS: AFTER THE TERM SHEET

To approve the investment, any company would follow these steps:

- Board approval of the investment via formal resolution
- Majority of shareholders consent via vote
- Execution of final documents: Once the term sheet is executed, attorneys draft detailed documents that include:
    - Share purchase agreement or subscription agreement including purchase details, company's representations and warranties, board composition, and voting matters
    - Investor rights agreement (IRA) including information rights, preemptive rights, registration rights, and affirmative and negative covenants[21]

- Affirmative covenants (or actions the company should take) include maintaining the existence of the corporation, paying taxes, maintaining insurance, complying with key agreements, maintaining accounts, and allowing access to premises

- Negative covenants (or actions the company should avoid) include changing the business, amending the charter, issuing stock, merging the company, conducting dealings with related parties, making investments, or incurring debt or financial liabilities

- Modifications to the certificate of incorporation to allow for the new shareholders to be recognized as well as ensure that the company does not take any actions that are not aligned with preferred shareholders' rights

- Issuing of share certificates to shareholders/investors

SUMMARY

Structuring a simple terms sheet is an art form as well as a science. The goal is to grasp the risks inherent within the opportunity and develop a set of conditions that would allow the investor to generate target returns. At the very early stages of an investment, savvy investors invest small amounts and get a seat at the table—as the opportunity grows, they double up. It is prudent to establish these terms as middle-of-the-road. Any exotic elements would cast a practitioner in an unfavorable light.

The lead investor, the one with the maximum investment, typically sets the terms. As goes the golden rule—he who has the gold makes the rules. The other syndicate investors have a choice—to accept those terms or not—but seldom have significant negotiating leverage. In anticipation of future financing, existing shareholders, at times and without much reason, will attempt to bump up the value significantly. If the bump-up is not justified, this creates the illusion of progress and can cause more harm than any benefit in the long run.

Everything that can be renegotiated will be renegotiated. In as much as 30 percent of subsequent financing, new investors renegotiated terms established at previous rounds. The most commonly renegotiated terms are (1) automatic conversion price, (2) liquidation preferences, (3) redemption maturity, and (4) funding milestones, vesting provisions, or performance benchmarks.[22]

As follow-on rounds occur, it is typical for the new lead investor of the follow-on round to set the valuation and terms. Down round financings are normal occurrences in the business of venture capital—companies often miss milestones and run low on cash. The only valuation that matters is the one at the time of exit.

The entire philosophy of term sheets is summarized in Steven Kaplan and Per Stromberg's words: "The elements of control: Board rights, voting rights and liquidation rights are allocated such that if a firm performs poorly, the venture capitalists obtain full control. *As performance improves, the entrepreneur retains/obtains more control rights. If the firm performs very well, the venture capitalists retain their cash flow rights, but relinquish most of their control and liquidation rights*. [italics added]"[23]