EQUITY FINANCING – TERMS AND TERM SHEETS

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Equity Financing

- The conditions around which you take money and give up equity
- When you talk about equity financing ultimately you are talking about signing a ‘term sheet’

Equity Financing

Common terms

- Valuation (Pre-money vs. Post-money)
- Convertible debt
- Capped vs. Un-capped Notes
- Preferred Stock
- Liquidation preferences
- Participating Preferred vs. Non-participating Preferred Stock
- Pro-rata Rights
- Option Pool
- Board Control
- Vesting

- *Common term sheet points*
- *Important to understand*

Funding Rounds

- Pre-seed
  - “we give you money before you even have a company”
- Seed Round; 1^{st} round of funding
  - Have raised a bit yourself; perhaps friends & family money
  - Now need small amount to keep things going
  - ~ $100k – 200k
  - Angel investors, etc.
  - Give up a lot more equity for smaller amounts of cash
  - Valuation around $1MM
- Round A
  - First time you raise VC money
  - Valuation around $3MM
- Round B
  - Second time you raise VC money
  - Taking $6MM out of a $12MM valuation

Valuation

- Valuation = the monetary value of your company
- For ventures your value is whatever you can convince investors you are worth (not enough ‘data’ to prove actual value)
- Terms are important because they determine equity stake founders give up during funding

Valuation: Pre-money vs. Post-money

- "Everything is worth what its purchaser will pay for it"
- Pre-money vs. post-money
  - Pre-money = company value before funding
  - Post-money = company value after funding
- Post-money valuation: value of the company after a financing event
- *Implied* pre-money valuation: total value of the company before a financing event
  - Creating value by cash
  - Creating value by making progress towards objectives
  - Creating value by reducing risks in its business model

Pre-money / Post-money

- “I’ll put in $2 million based on three pre-money”
- “I’m thinking two-thirds based on three pre-; that will get you to five post-”
- “I’m looking for two-fifths of the company post-money, and for that I’ll put up the two”
- “It’s worth $3 million pre-money, and I want to own 40 percent of it after we close”

- VC is proposing that the company is worth $3 million before the investment of $2 million
- Therefore, worth $5 million immediately after the investment
- Ownership share being requested is an amount equivalent to 66.67% of the equity based on the pre-money number (i.e., $2 million / $3 million), which will be 40% of the company measured immediately after the closing of the deal (i.e., $2 million / $5 million)

Convertible Debt (Convertible Notes)

- Sometimes in the beginning, because a company is young with unproven track record, quantifying the ‘value’ is arbitrary
- Convertible debt (aka convertible notes) allows startups to raise money while delaying the valuation discussion (i.e. delay until the company is more mature)
- Although technically debt, convertible notes convert to equity later
  – usually when the venture receives formal funding (e.g. notes convert to equity during a Series A round)
- Investors who agree to convertible notes usually receive a discount in the very early stages of a business
  – Their cash converts to equity at a more favorable ratio than investors who come later

Capped Notes vs. Uncapped Notes

- Although convertible notes delay the valuation discussion, sometimes investors still want the right to have a say in the future valuation

- A “capped” round means that investors and founders put a limit on the valuation at which investors’ notes convert to equity.

- “Uncapped” means there is no guarantee of how much equity the convertible debt will be able to purchase
  - ‘uncapped’ is usually best for the founder

Example: Pre-money vs. Post-money Valuation

Example: "Capped"

- A company raises $500,000 in convertible notes at a $5 million cap
- Investors will own at least 10% of the company after the Series A round
  - $500,000/$5M = 10%

Example: "Uncapped"

- Company raises $5mn in uncapped round
- Later in Series A, founders are able to convince investors to agree to a $10 mn valuation
- Convertible note holders are left with just 5% of the company
  - ½ of what they get if they capped the round at $5 million

Preferred Stock

- When a VC invests, they are granted “preferred stock”
- Preferred stock enables the VC rights that are not held by ‘common’ stock holders
- Series A, Series B, etc. rounds refer to the class of preferred stock issued at each fundraising round.

TERM SHEET

Issuer	
Investors	
Current Outstanding Securities	15,456 shares of Class A Voting Common Stock ("Class A Common", or "Common") 94,244 shares of Class B Non-Voting Common Stock ("Class B Common") and Options to purchase 10,000 shares of Class B Common
Securities to be Issued	
Security 1	Series A Redeemable Preferred Stock ("Series A Preferred") **Price per Share:** $1,000 ("Series A Original Purchase Price") **Number of Shares:** 1,800
Security 2	Series B Convertible Preferred Stock ("Series B Preferred") **Price per Share**: $3.60 ("Series B Original Purchase Price") **Number of Shares:** 55,556 (Series A Preferred and Series B Preferred together, the "Preferred")

Post-Investment Ownership

The Company will be capitalized such that post investment common share equivalents will be held as follows:

	Shares/Equivalents	% of Total Post-Inv.
New Investors	55,556	27.9%
	12,600	6.3%
Other SHs/Founders	35,395	17.8%
Management:		
Founders	61,705	31.0%
Reserved Shares-Granted	6,000	3.0%
Reserved Shares-Available	27,778	14.0%
Total Management	95,483	48.0%
Total Share equivalent ownership	199,034	100%

Returns by stock type

	Amount due to…		Total Amount Due
	Original Purchase Price	Accruing Dividends	
Redeemable Preferred (Series A) Stock holders			
Convertible Preferred (Series B) Stock holders (If NOT converted)			

Returns by stock type

	Amount due to…		Total Amount Due
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Dividends	A cumulative dividend will accrue on the Preferred at the rate of 8% per annum compounded annually ("Accruing Dividends"). Accruing Dividends will be payable only (a) if, as and when declared by the Company's Board of Directors, (b) upon the liquidation or winding up of the Company, or (c) upon redemption of the Preferred. No dividends may be declared or paid on the Common until all Accruing Dividends have been paid in full on the Preferred. The Preferred will also participate parri passu in any dividends declared on Common. Dividends will cease to accrue in the event that the Investors convert their holdings to Common Stock.

Returns by stock type

	Amount due to…		Total Amount Due
	Original Purchase Price	Accruing Dividends	
Redeemable Preferred (Series A) Stock holders	$1,800,000	$\$1{,}800{,}000 \times ((1.08)^4 - 1)$ = $648,880	$2,448,880
Convertible Preferred (Series B) Stock holders (If NOT converted)	$3.6 x 55,556 = $200,000	$\$200{,}000 \times ((1.08)^4 - 1)$ = $72,100	$272,100

Returns by stock type

Terminal Value	1,000	2,000	3,000	4,000	5,000	10,000
<u>By Stock type*</u>						
Amount to Redeemable Preferred (Series A) Stock holders						
Amount to Convertible Preferred (Series B) Stock holders**						
…if not converted to Common						

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Returns by stock type

Terminal Value	1,000	2,000	3,000	4,000	5,000	10,000
<u>By Stock type*</u>						
Amount to Redeemable Preferred (Series A) Stock holders	1,000	2,000	2,449	2,449	2,449	2,449
Amount to Convertible Preferred (Series B) Stock holders**						
…if not converted to Common			272	272	272	272

[($4,000 - $2,449) * 27.9%]=433

Returns by stock type

Terminal Value	1,000	2,000	3,000	4,000	5,000	10,000
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			449	2,449	2,449	2,449
			272	272	272	272

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Amount to Convertible Preferred (Series B) Stock holders**			**272**	**433**	**712**	**2,107**
…if not converted to Common			272	272	272	272
…if converted to Common			154	433	712	2,107

[($4,000 - $2,449) * 27.9%]=433

Returns by stock type

Terminal Value	1,000	2,000	3,000	4,000	5,000	10,000
<u>By Stock type*</u>						
Amount to Redeemable Preferred (Series A) Stock holders	**1,000**	**2,000**	**2,449**	**2,449**	**2,449**	**2,449**
Amount to Convertible Preferred (Series B) Stock holders**	**–**	**–**	**272**	**433**	**712**	**2,107**
…if not converted to Common			272	272	272	272
…if converted to Common			154	433	712	2,107
Amount available to all other Common Stock holders***	**–**	**–**	**279**	**1,118**	**1,839**	**5,444**

Terms of interest

- Economic terms
- Control terms
- Other types of terms

Liquidation Preference

Liquidation Preference

In the event of a liquidation or winding up of the Company, a) holders of Series A Preferred shall be entitled to receive, in preference to the holders of Common, an amount ("Series A Liquidation Amount") equal to the Series A Original Purchase Price plus any Accruing Dividends which have not been paid and b) holders of series B Preferred shall be entitled to receive, in preference to the holders of the common, the amount (Series B Liquidation Amount") equal to the greater of (1) the Series B original Purchase Price plus any Accruing Dividends which have not been paid or (2) such amount that holders of Series B Preferred would have received had their shares been converted to Common immediately before the Liquidation Event.

A consolidation or merger of the Company or sale of all or substantially all of its assets or the sale of all or substantially all of the Company's outstanding equity securities will be deemed to be a liquidation or winding up ("Liquidation Event") for purposes of the Liquidation Preference.

Liquidation Preference

- VC's primary interest is to make money
- VC's ultimately have to liquidate, aka sell their stakes
- Usually liquidation is either an acquisition or an IPO
  - a liquidation event could also come in the form of a bankruptcy…
- Liquidation preferences define who gets paid when:
  - Example: company goes bankrupt, and assets are not enough to pay everyone; it matters the order of who gets paid
  - Usually creditors (banks, etc.) get paid first, then preferred stockholders, then, common stockholders
- Liquidation preferences also relevant when things go well
  - standard liquidation preference is 1x, i.e. preferred stock owners must get their money back before common stock holders get anything

Pro-rata Rights

Right of First Refusal

Each holder of Preferred shall have a right of participation to purchase a share of all offerings of new securities of the Company (other than Reserved Shares) equal to the proportion which the number of shares of Preferred held by such holder (on an as-converted basis) bears to the Company's total issued and outstanding shares of Common. Such right shall terminate immediately prior to closing of a qualified public offering.

In the event that any of the holders of Common or Preferred proposes to sell or otherwise transfer any shares of stock of the Company, or any interest in such shares, holders of Preferred shall have a pro-rata right of first refusal to purchase such shares, at the same price and terms as those offered to the selling shareholders by any third party (excluding distributions or transfers to affiliates of such holder).

Pro-rata Rights

- Pro-rata is Latin for “in proportion”
- Pro-rata rights are investors rights that allow them to participate in later funding rounds
  - Point is so that they maintain the amount of equity % they own
- Example:
  - Company raises a $5 million Series A round from an investor at a $20 million post-money valuation (investor has 25% of the company)
  - Later company raises $10 mn at a $100 mn valuation
  - In order to keep 25% stake, investor must invest at least 25% of new funding (~$2.5 mn). Otherwise stake is reduced

Redemption Rights

Redemption

At any time following the fifth anniversary of the sale of Series A Preferred, the Company, upon the request of the holders of at least 66 2/3 % of the Series A Preferred, shall redeem any portion or up to 100% of the Series A Preferred shares, by paying in cash 110% of the Original Purchase Price per share plus all accrued but unpaid dividends.

Redemption Rights

- The right to force the start-up to repurchase (redeem) its own stock at some point in the future. This right protects the external investor from illiquidity in case alternate exit events are not available.
- Potential problems: future investors may demand these rights; parallel rights for the entrepreneur in buying back stock?

Option Pool

- Option pool refers to equity reserved for future hires (employees)
- Size of option pool impacts your company's valuation and your ownership
- Option pools are often included in pre-money valuation
- Example:
  - Investors invest $2 mn at $10 mn pre-money (implies $12 mn post-money)
  - Option pools expressed as a percentage of post-money valuation
  - If deal includes a 20% option pool, that means the pool is worth $2.4 million
  - Founders $10 mn pre-money valuation is now a $7.6 mn pre-money valuation.
  - Investors still own 16.7% but founder is diluted because option pool comes from management's stake

Board Control

- Founders and companies responsible to shareholders and the board
- Even if founders manage to maintain controlling stake outside board members still exert influence on how the company runs and makes important decisions
  - Even to the point where the board can fire you at will
- Board composition post-funding important and needs to be navigated very carefully during fundraising negotiations
  - One suggestion is to push for neutral board members, that both entrepreneurs and investors agree upon

Vesting

- Important financial term and many investors will expect you to know your vesting schedules
- Vesting schedules…
  - are for employees that receive equity
  - determine when those employees can access equity
- Typical vesting schedules take about four years to fully vest and involve a one year ‘cliff’
  - ‘Cliff’ simply means that employee’s shares vest for at least one year. After that year, typically 25% of the employee’s equity is released, and the rest vests on a monthly or quarterly basis

Summary

Key points:

- The conditions around which you take money and give up equity
- Understanding valuation and term sheets
- Terms in the term sheet to keep in mind:
  - Economic terms
  - Control terms
  - Other terms

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