The Wharton School

Factual Setting for Term Sheet Negotiation between Hi-Tech, Inc. and Two Venture Capital Funds

Background of Hi-Tech, Inc. Three graduate students from the Computer Science Department of MIT have spent the last two years in their free time developing a new personalized search engine technology based on a set of complex software algorithms. This technology transparently tracks and learns the personal "surfing" patterns of individual users on the Internet. Using this accumulated information, the technology increasingly "personalizes" these queries to the tastes and interests of the user, enabling the retrieval of Web-based information that is specific to the user.

The three founders decided to form a company, Hi-Tech, Inc., believing that their new technology has the potential to substantially advance the state of Internet-based information retrieval. Market research by the three students leads them to believe that the market for their technology is substantial and immediate, with no competing products or technologies in space.

Only one of the founders has any previous management experience in a venture-backed technology company, and the other two have never held a job before. Nevertheless, they are prepared to abandon their graduate activities to take up management positions within Hi-Tech on a full-time basis. MIT has expressed no interest in the company or its technology. The founders are as follows:

- Kishore, the spokesman for the three founders and the designated Chief Executive Officer of the new company. Kishore is strong in market development and has keen instincts in anticipating strategic trends in the search engine space, but has never had responsibility as the senior executive of a company.

- Mary, a talented software developer and the brains behind the complex software algorithms that are the basis of the company's core product. Her role is an indispensable one during the product development phase of the company. She is designated as the company Chief Technology Officer.

- Robert, also a capable software developer who has personally funded the activities of the three founders through the purchase of necessary computer systems and tools and rented out a small office for them to work in their off hours. He is out of pocket a total of $175,000 in expenses to support their efforts. Robert has been designated the Vice President of Product Engineering and Chief Financial Officer of the startup.

The founders spend several weeks pulling together a business plan and conclude they initially need to raise $5 million to move their new company forward. They estimate that the company might need future round(s) of financing before the business is profitable and self-sustaining at a level that would permit the company to access the public equity markets through an initial public offering. The founders believe that an IPO could be possible within 4-5 years out from inception, or that a sale of the company might be possible sooner depending on the effectiveness of the company's product development efforts. The founders are biased in favor of an IPO, since this would give the company the chance to retain autonomy and realize the founders' ambitions to see their search engine technology commercialized.

During the next 12 to 18 months, the company's business plan calls for hiring approximately 50 employees. They believe that the company will be principally engaged in product development activities for the first two years.

The summary five-year financial projections of the new company prepared by the founders are as follows:

	2026	**2027**	**2028**	**2029**	**2030**
Revenue ($)	225,000	1,450,000	7,875,000	22,500,000	52,000,000
Net Income (Loss) ($)	(3,750,000)	(2,375,000)	(750,000)	275,000	3, 450,000

The founders have talked among themselves and identify several objectives that they would like to attain in negotiating terms for a $5 million investment by a venture capital investor. These objectives are as follows:

- ☐ A high pre-money valuation, somewhere in the range north of $20 million.
- ☐ Access to funding as quickly as possible, since the "window" for implementing this technology is very short in a competitive environment.
- ☐ As founders and shareholders, retaining voting control of their new company, especially in respect of any future decision whether to sell the company or to move forward on an IPO.
- ☐ Assurances to the founders that they will retain day-to-day operating control of the company, and have the opportunity to keep their executive positions in the company as long as the company is successful.
- ☐ The "mindshare" of the senior partners within the venture fund that completes an investment in the company.
- ☐ Assurances that the investing venture fund will participate in future investment rounds in the company.

- ☐ Repayment to Robert of the $175,000 that he extended to the company for initial expenses.

- ☐ Financial security to each of the founders, through a buy/sell arrangement among themselves or including the venture investors, in the event any of the founders should suffer death of disability during his or her tenure with the company

<u>Pre-Financing Capitalization of Hi-Tech, Inc</u>. In the course of incorporating and organizing Hi-Tech, Inc., the founders take an equal equity stake in the company — 1,000,000 shares each — and have hired a few early-stage employees, who receive common stock in the Company. In addition, anticipating the need to hire more employees in the next year, the founders set aside a stock reserve for the grant of stock options.

These activities have resulted in the following capital structure for Hi-Tech, Inc.:

Founders	3,000,000 shares of common stock
Early stage employees	500,000 shares of common stock
Stock reserve for future option grants	1,500,000 shares of common stock

The founders make several presentations before a range of possible venture capital firms, two of which continue to express interest in continuing diligence and discussions with the founders regarding a potential investment.

As the founders continue discussions with these two separate funds, they recognize that it might be prudent to maintain an "ethical" wall between the two funds, so that neither fund knows the identity of the other nor the investment terms of the other that are being offered. The founders agree that this is the best way to proceed, but recognize that there might be circumstances where breaching this "wall" could be in their interest in negotiating favorable terms.

<u>Acorn Capital Interest.</u> In the course of these presentations, the founders meet with Acorn Capital, an East Coast-based venture fund with offices in Palo Alto, California. Acorn has a mercenary reputation, but has also been highly successful in selecting and supporting early stage companies. The significant returns that characterize Acorn's fund performance are well known in the industry. Acorn's general partners in most cases had successful careers in banking and private equity before moving over to focus on venture capital activities in Acorn. As a result, they have a reputation for micromanaging their investments. In addition, among the general partners, there is not much expertise in understanding the search engine technology that Hi-Tech is pursuing.

The founders of Hi-Tech also know that in the case of two other startup companies in Acorn's portfolio, Acorn has fired the founding team for failure to meet the business plan objectives and replaced them with professional management. Acorn is quite open about its objective to generate at least a 50% return on investment and has little compunction about changing out the founders/management team if necessary to realize that objective.

The general partners of Acorn, after meeting with the founders, determine to move forward with an investment, subject to reaching an agreement in principle on a term sheet. Since the partners of Acorn are engaged heavily in fundraising for a new fund, none of them is able to commit personally to attending Hi-Tech's board meetings or monitoring the company's progress. Instead, they offer the services of a recently hired "principal" in the firm with operating experience and modest experience as a VC. This principal will be charged with the responsibility for attending meetings and staying abreast of company developments and will have access to the senior partners if there are difficult business judgments about Hi-Tech to be made. When Acorn's fundraising is completed and there is more time available, one of the Acorn partners will take on this day-to-day responsibility.

Acorn Capital is enthused about a possible investment in Hi-Tech, Inc., and has a number of its own objectives in structuring terms for an investment, which it is willing to share with the founders of Hi-Tech, Inc.:

- ☐ An initial conception of valuation that would anticipate a liquidity exit for the company's investors in five years and the need for $10 million in additional equity at the beginning of year three. In addition, some valuation research by Acorn, comparable public companies in the sector suggests an average P/E multiple of 60x.

- ☐ The need to manage investment terms to ensure a significant return on investment for Acorn's LPs, including the right of Acorn to maintain its equity interest in the company in the face of future stock issuances.

- ☐ In return for getting to an acceptable valuation, interest in negotiating strong veto rights and other controls over the operations and management of the Company. In particular, Acorn is skeptical that Kishore has the skillset or experience to lead the Company to the level of growth required to meet Acorn's investment objectives.