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 the 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 $15 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

Pre-Financing Capitalization of Hi-Tech, Inc. 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.

Interest of Galaxy Investment Capital. In the course of these presentations, the founders meet with Galaxy Investment Capital, a local venture fund based in San Francisco, California.

Galaxy has a reputation for funding companies with leading edge technologies which sometimes are ahead of their targeted commercial markets. Their approach to their portfolio investments is a thoughtful one that is the product of significant advance research and understanding of the core technology. Although Galaxy made some bad "bets" on companies during the pre-"bubble" time period, they have also made some investments that played out brilliantly. As a result, the performance returns for Galaxy's fund has been mixed financially. In addition, if Galaxy wins the investment offer with Hi-Tech, Inc., it will effectively exhaust the current fund; if Hi-Tech should require follow-on financing, for Galaxy will be required to successfully raise and close a new fund for it to participate in that next financing.

The Galaxy partners are known to be a congenial group, with a history of rational dealings with the management teams of their startup companies. The partner who is "championing" sponsorship of Hi-Tech at the weekly Galaxy partnership meetings has been with the firm for 15 years and has an appreciation of the search engine market and trends in related technology. He also knows well from painful experience the challenges and competition that early-stage companies in this space are likely to encounter. Galaxy tends to be conservative in its initial valuation of candidate companies for investment.

The general partners of Galaxy, after meeting with the founders, determine to move forward with an investment, subject to reaching an agreement in principle on a term sheet. Galaxy 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 candid in sharing with the founders of Hi-Tech, Inc.:

- ☐ A bottom-of-the-range pre-money valuation, based on some of the bad experiences of the sponsoring Galaxy partner. Galaxy believes that the company will require at least another $15 million in equity at the beginning of year four and thinks that the exit horizon for the company's investors is at least six years away. Galaxy also doubts the optimism of the company's projections, and thinks a 60% discount rate is appropriate for Hi-Tech. Galaxy also substantially discounts the P/E multiple of comparable search engine public companies to 40x, given the advantages of size of these companies.

- ☐ Concerns about the inexperience of the founders as managers, but some willingness to accommodate their management aspirations in the new company.

- ☐ Interest in negotiating veto rights and other controls over the strategic direction of the Company.

- ☐ Galaxy counts among its limited partners a number of institutions and corporate organizations which are well connected with the search engine industry. Galaxy believes that many of these limited partners could be introduced to Hi-Tech, Inc. and significantly enhances the Company's revenue growth.