Understanding Term Sheets and Deal Structures

Venture Capital Financing Overview

CED's Entrepreneurs Only Workshop
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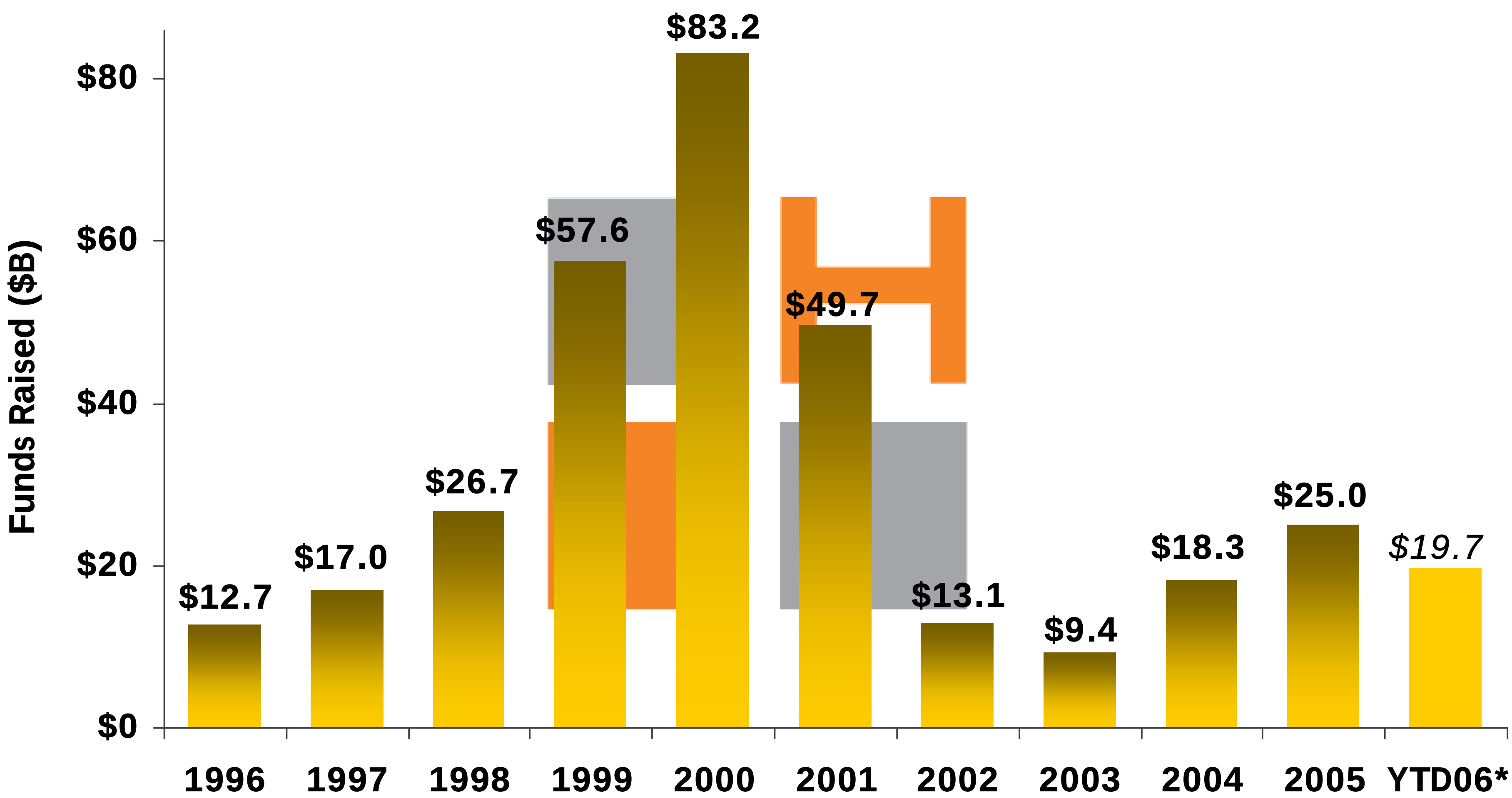
"Starting a company is like having a baby – fun to conceive but hell to deliver."

- Anonymous

U.S. Fundraising On Track in 2006

Commitments to Venture Capital Funds

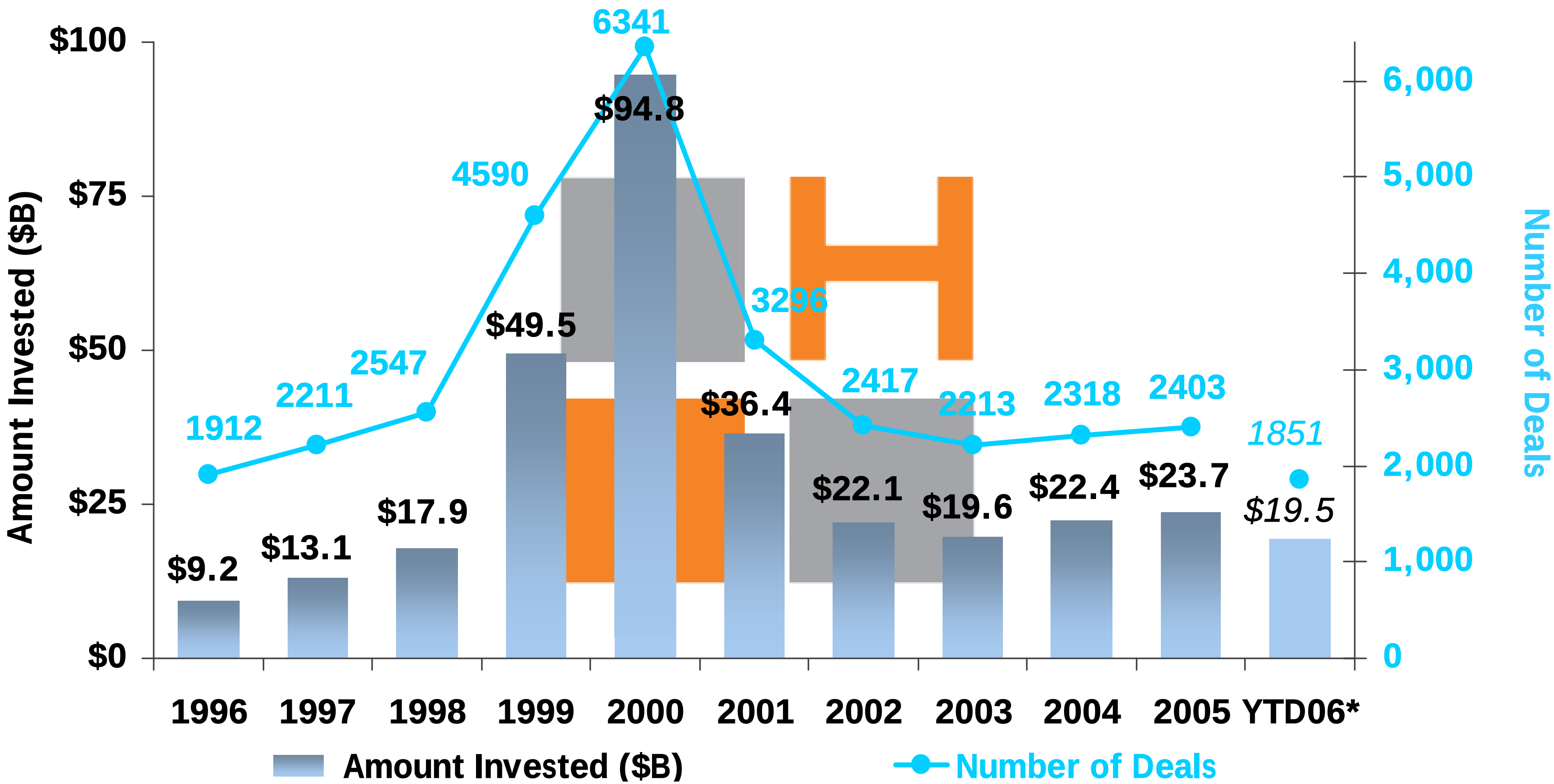


YTD06*: 1Q06 - 3Q06

Source: Dow Jones VentureOne

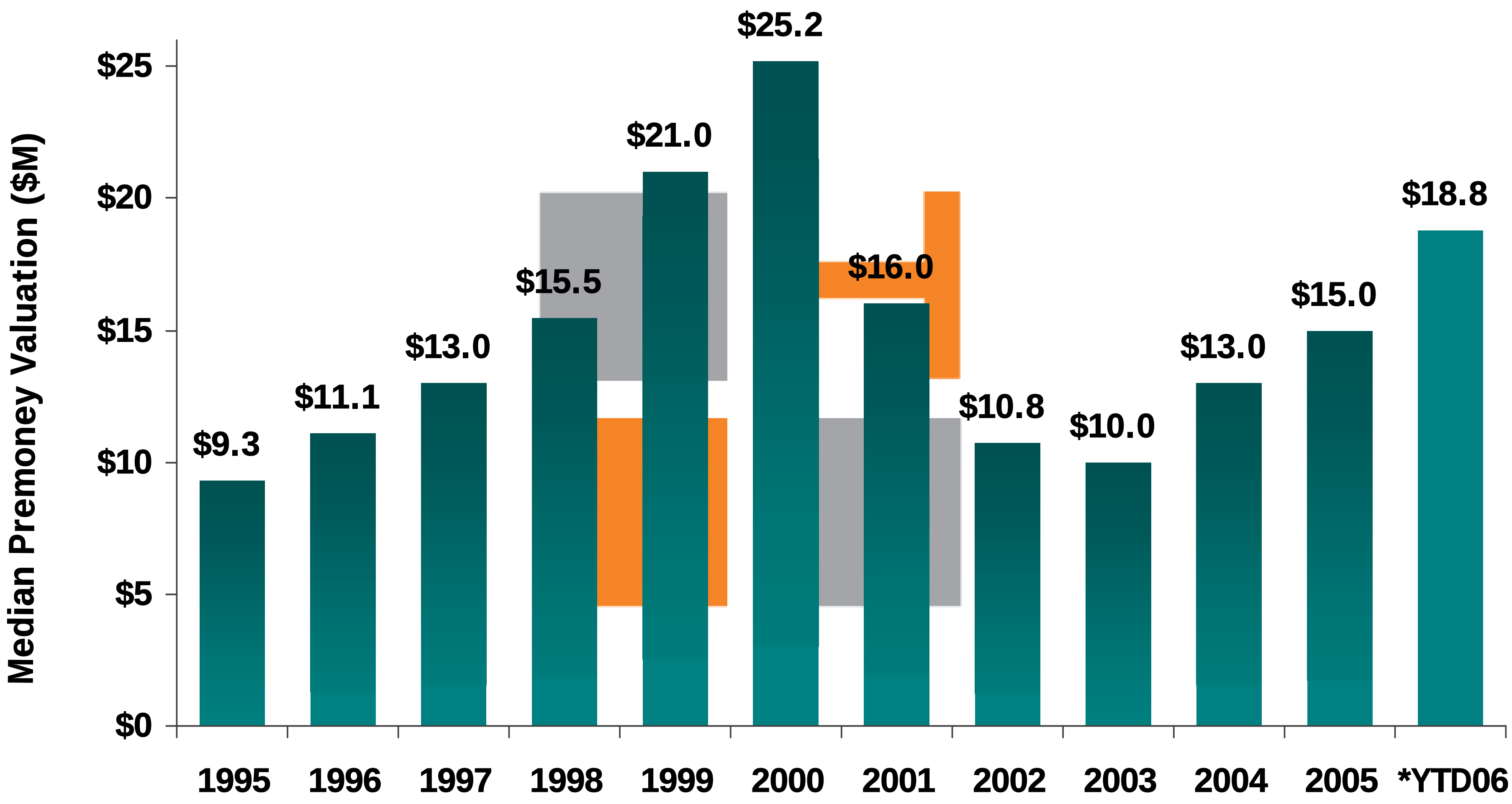
Investment Level On Track to Surpass 2005

Deal Flow and Equity into Venture-Backed Companies



Valuations Continue Upward Trend

Median Premoney Valuation by Year

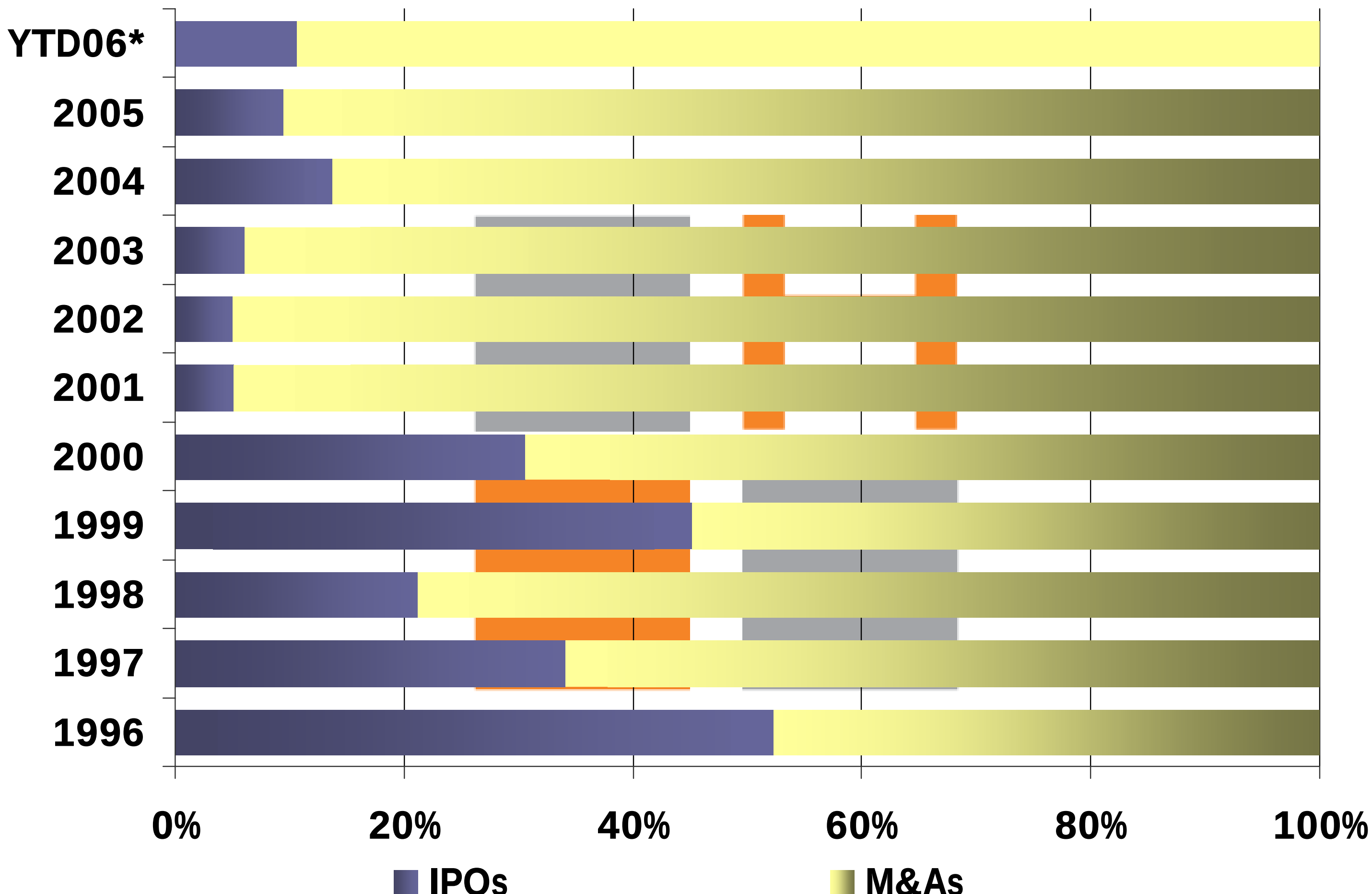


*YTD: 1Q06-3Q06

Source: Dow Jones VentureOne

M&As Remain Primary Exit Option

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

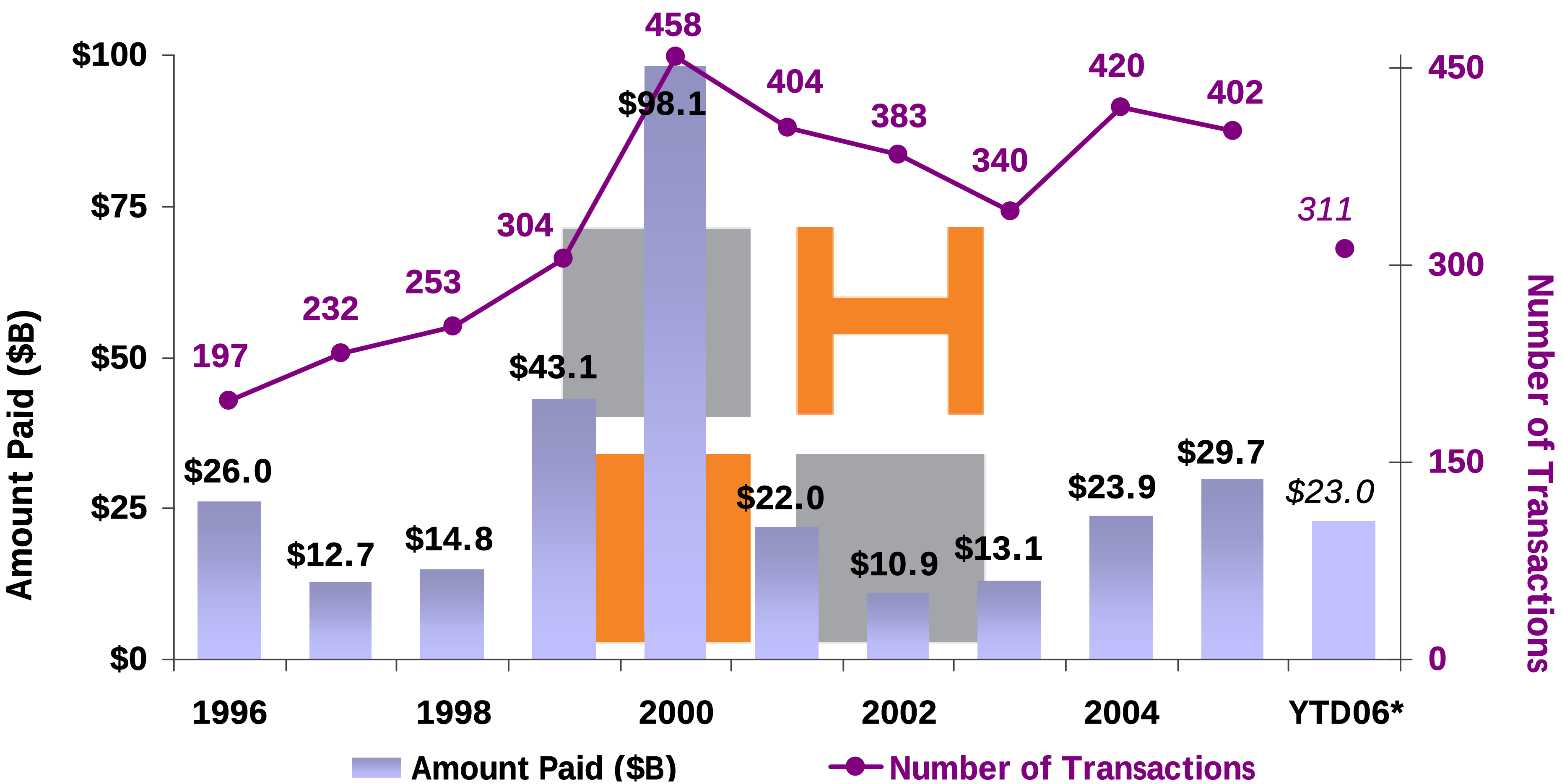


YTD06*: 1Q06 – 3Q06

Source: Dow Jones VentureOne

Amount Paid in M&As on Track in 2006

Transactions and Amount Paid in M&As

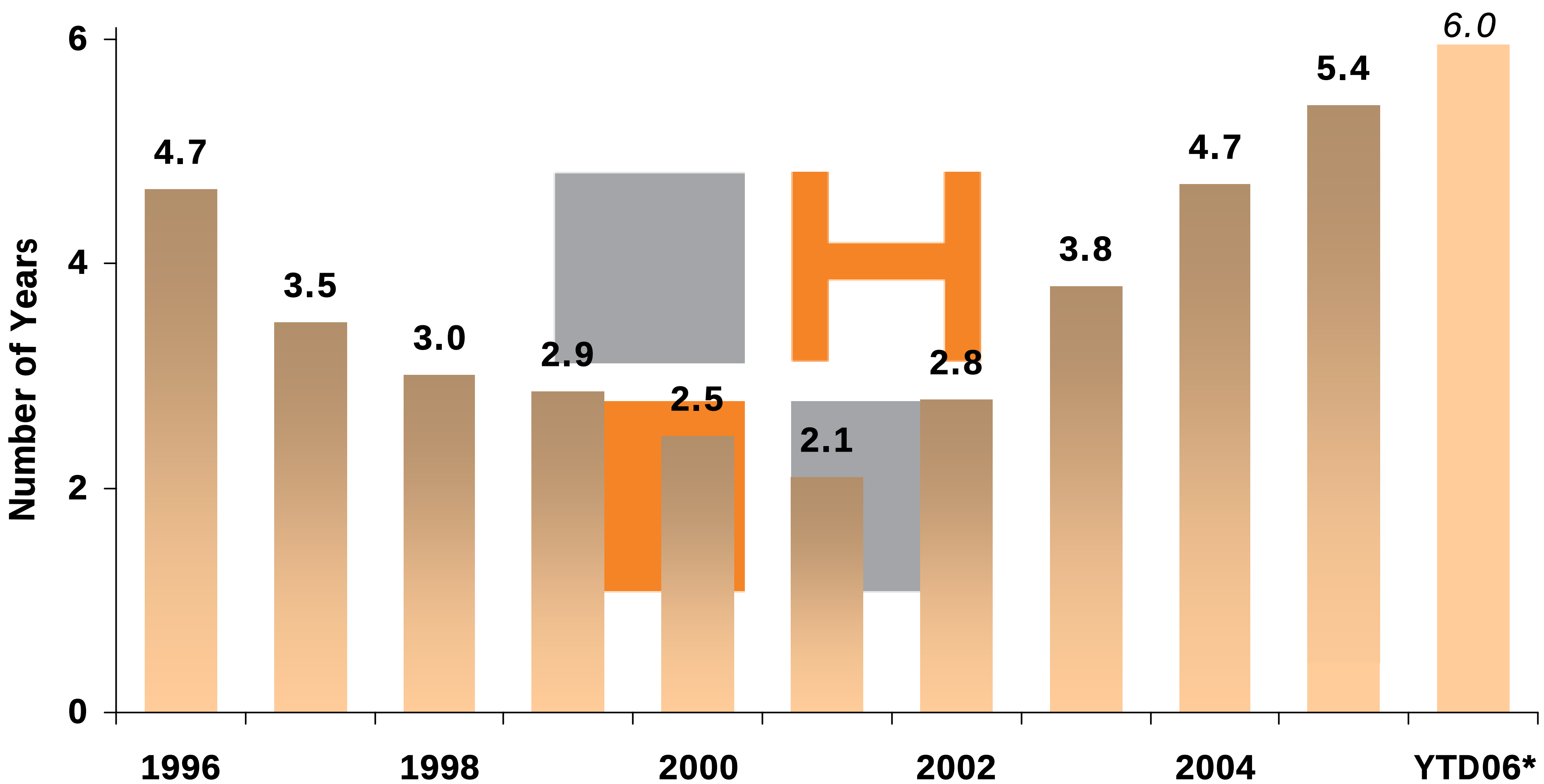


YTD06*: 1Q06 – 3Q06

Source: Dow Jones VentureOne

Older Companies Being Acquired

Median Time From Initial Equity Funding to M&A

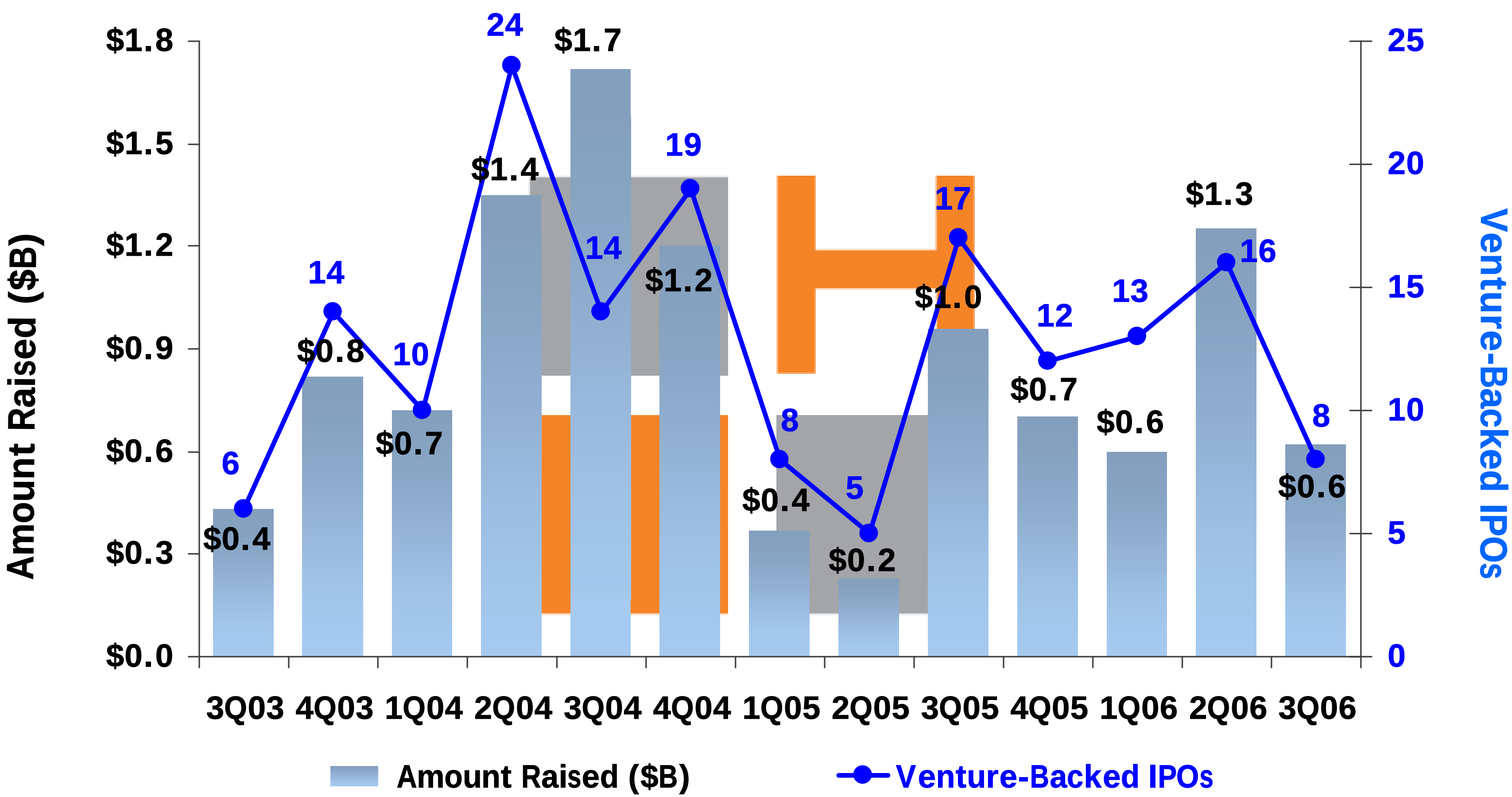


YTD06*: 1Q06 - 3Q06

Source: Dow Jones VentureOne

IPO Activity Declines in 3Q'06

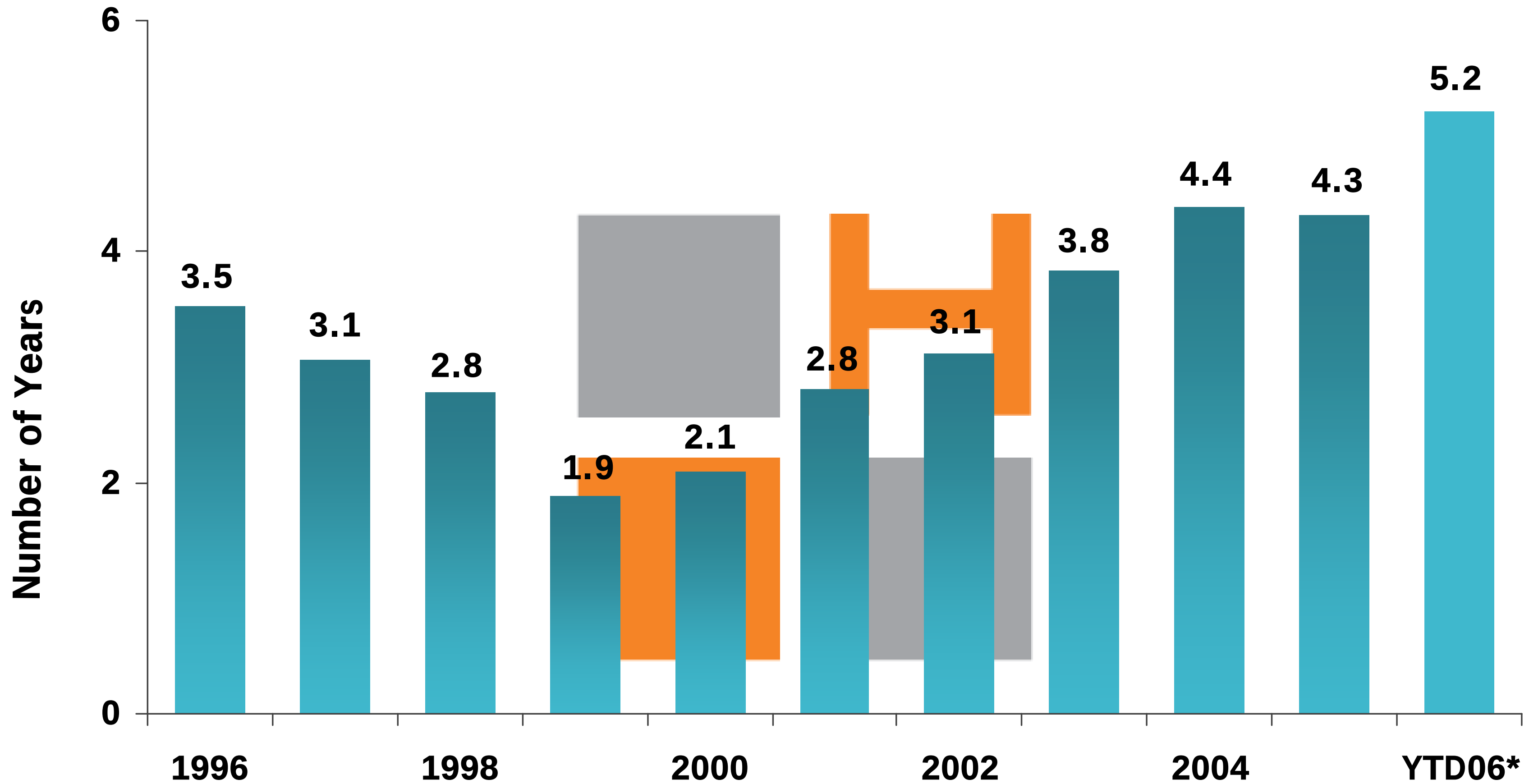
Deals and Total Amount Raised Through IPOs



Source: Dow Jones VentureOne

Half of 2006 IPOs from Vintage Year 2000

Median Time From Initial Equity Funding to IPO



YTD06*: 1Q06 - 3Q06

Source: Dow Jones VentureOne

Structure of Typical Start-Up

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

Sources of Capital

- Self Funding (FFF)
- Angel
- VCs
- Corporate Investment

Angel Investors = High Net Worth

Individuals with High Risk Appetite

- Early stage preference
- Profile – "one and done"
- $25K - $50K
- Bell cows
- QBV Registration
- Endangered species
- Individuals (network)
- Organized Groups (PAN, CAP, CHAP, WIN)

Pro/Con on Angel Investors (Individuals)

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

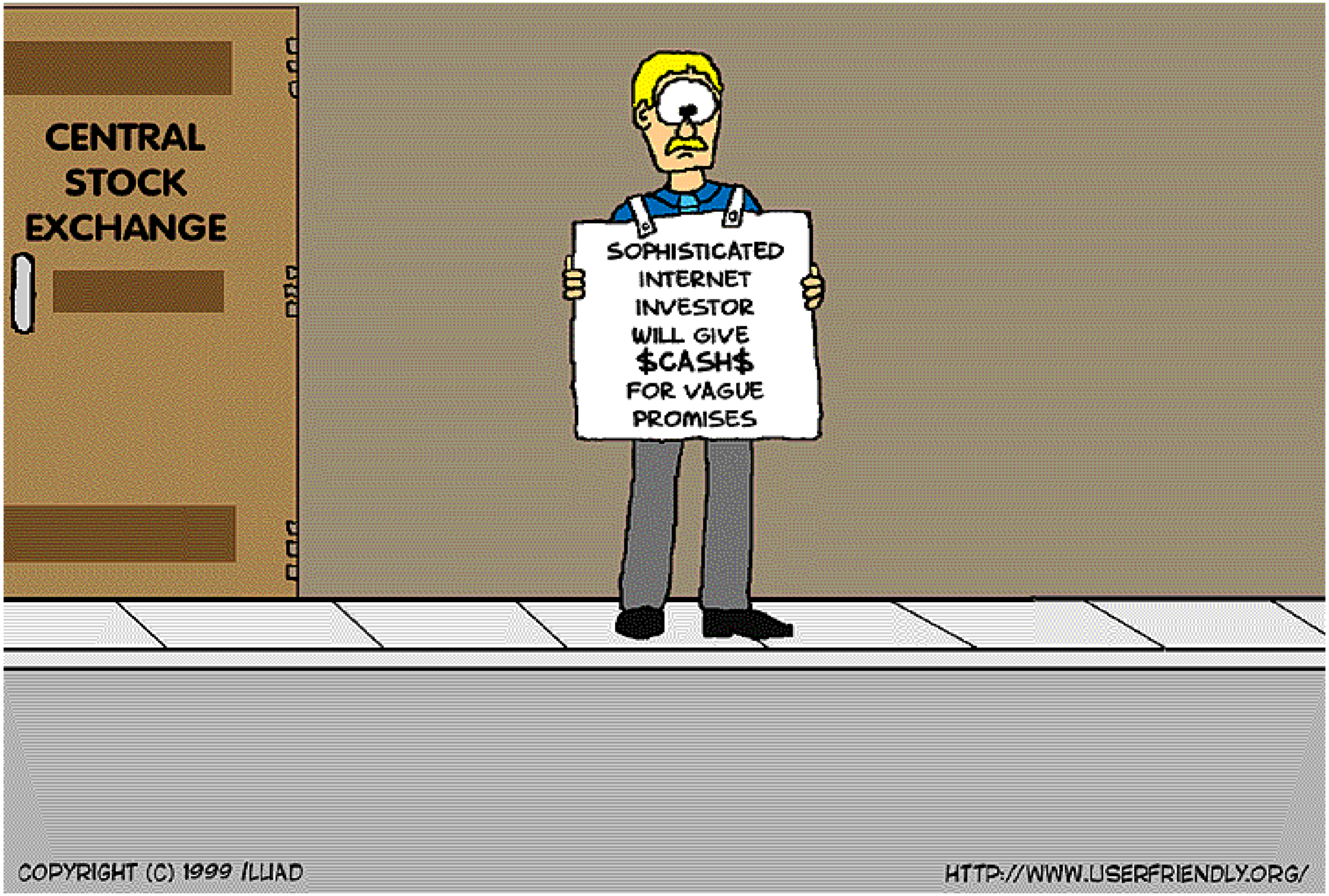
Current Angel Financing Environment

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

Venture Capital Requirements

- 25-30% Internal Rate of Return
- Market Size/Position
- Management Team "Bet on Jockeys, not Horses"
- Clear Exit Strategy

Past Funding Environment



Current Funding Environment

- Buyers' (Investors') Market
- Investors Buried with Deals
- Potential Exits Improving
- Valuations Creeping Up
- Terms Still Heavily Negotiated

4 Principles of Term Sheets

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

Valuation Calculation

	Capitalization	
	Pre-Money	Post-Money
Outstanding Common Stock	2,000,000 shares	2,000,000 shares
Outstanding Preferred Stock	0 shares	2,000,000 shares
Outstanding Stock Options	250,000 shares	250,000 shares
Reserved Stock Options	7500,000 shares	750,000 shares
	3,000,000 shares	5,000,000 shares
Valuation: (Series A Preferred Purchase Price = $2.00 per share)	$6.0 million	$10.0 million

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

Control

Board of Directors

- Key Rights
  - Appoint and fire officers
  - Set policy/Make major decisions
  - Issue options
- Number of directors
- Investors: Election of BOD members by "series" or "class" vote

Control

Protective Provisions

Must obtain approval of the Preferred to:

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

Control

Typical Additional Investor Rights

- Information
- Co-Sale
- First Refusal (Pro Rata)

Exit Strategy - Redemption

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

Exit Strategy – IPO

Registration Rights

- Demand Rights
- S-3 Rights
- Piggy Back Rights

Exit Strategy – Acquisition

Liquidation Preference

- **Multiple of Liquidation Preference**
  - Preferred gets multiple times investment back before Common gets any money
- **Participating Preferred**
  - Preferred gets investment back first, remaining proceeds shared between Common and Preferred pro-rata
- **Limited or Capped Participation**
  - Preferred gets investment back first, remaining proceeds shared between Common and Preferred until Preferred reaches a multiple of investment (usually 2x – 5x) and remainder goes to Common
- **Non-Participating Preferred**
  - Preferred gets investment back first, remaining proceeds go to Common

Effect of Liquidation Preference

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

Effect of Liquidation Preference

4x Multiple of Liquidation Preference with Participation:

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

<u>Total return</u>

Preferred:	11.5 million
Common:	3.5 million

Effect of Liquidation Preference

Participation Capped at 4x:

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

Total return

Preferred:	$8 million
Common:	$7 million

Effect of Liquidation Preference

Non-Participating Preferred:

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

Total return

Preferred:	$7.5 million
Common:	$7.5 million

Down-Side Protection

Anti-Dilution Protection

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

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

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

Down-Side Protection

Don't Forget Exclusions

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

Anti-Dilution Calculation

Facts:

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

Anti-Dilution Calculation

Ratchet:

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

Anti-Dilution Calculation

Broad-Based Weighted Average:

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

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

Conversion Ratio: $1.00 ÷ $0.8571428 = 1.166

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

Anti-Dilution Calculation

Narrow-Based Weighted Average:

Formula: $\dfrac{\text{(Common + Preferred) x Conversion Price + Amount Raised}}{\text{Common + Preferred + New Securities Issued}}$

Calculation: $\dfrac{(3{,}000{,}000 + 5{,}000{,}000) \text{ x } \$1.00 + \$2{,}000{,}000}{3{,}000{,}000 + 5{,}000{,}000 + 4{,}000{,}000} = 0.8333333$

Conversion Ratio: $1.00 ÷ $0.8333333 = 1.2

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

Pop Quiz

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

A Tale of Two Companies

Both companies financed under exactly the same conditions:

Initial Capitalization

3,000,000 founders shares

2,000,000 shares initial reserved for options

Series A Financing

Company raises $5M at a $5M pre-money valuation

Series B Financing

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

Series C Financing

Company raises $21M at a $63M pre-money valuation (and adds 1M shares to option pool) at a $84M post-money valuation

Key Financing Terms

SmartCo

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

SlowCo

- Ratchet anti-dilution protection
- 4x Participating Preferred with no cap

Cap Tables Following Financing

SmartCo	
Common	3,000,000
Options	4,000,000
Series A	5,000,000 (6,000,000)
Series B	4,000,000
Series C	5,666,666

Common Ownership: 13.24%

SlowCo	
Common	3,000,000
Options	4,000,000
Series A	5,000,000 (10,000,000)
Series B	4,000,000
Series C	7,000,000

Common Ownership: 10.71%

Payout Scenarios

- **How much $ do the Common holders get in a $40 million acquisition?**

SmartCo	Approximately $1.6 million (or 4%)
SlowCo	-0-

- **A $100 million acquisition?**

SmartCo	Approximately $10.5 million (or 10.5%)
SlowCo	-0-

- **A $200 million acquisition?**

SmartCo	Approximately $23.7 million (or 11.85%)
SlowCo	Approximately $9.4 million (or 4.7%)

- **A $500 million acquisition?**

SmartCo	Approximately $66.2 million (or 13.24%)
SlowCo	Approximately $41.6 million (or 8.32%)

Moral of the Story

In order to know

if that new Term Sheet

you received is a

Trick or a Treat –

<u>You have to know your terms</u>!

Questions?

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