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Anatomy of a Venture Capital Term Sheet
AKA entrepreneur-investor prenuptial agreement

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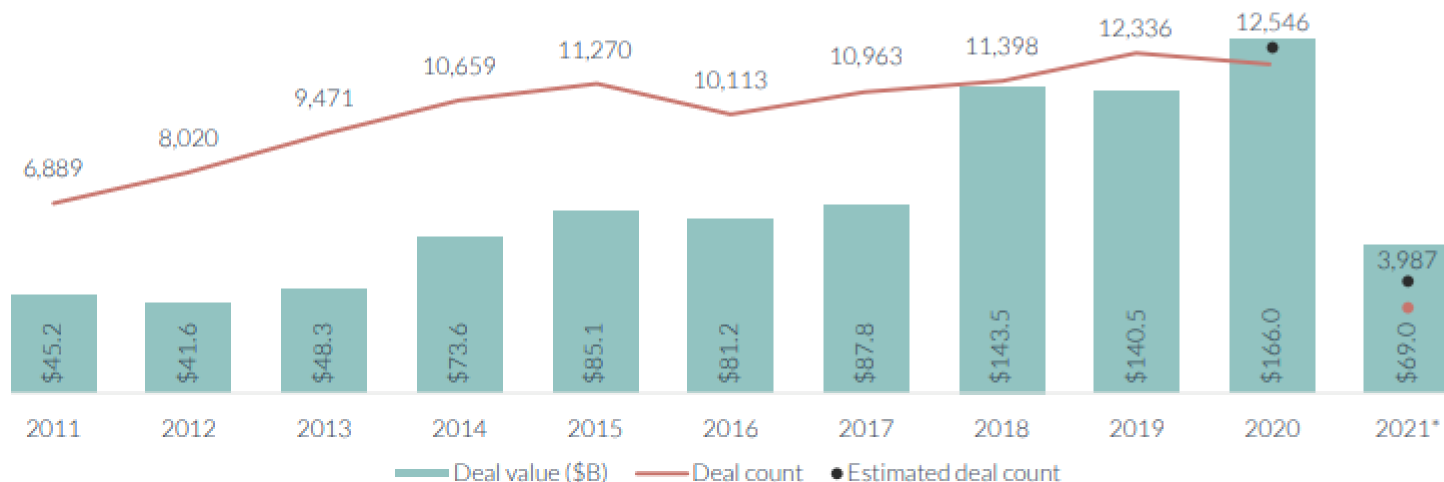
Today's topics

- Trends in Asian VC
- Staged Financing
- Anatomy of a term sheet
- Structuring a VC deal

LP Investment in VC Is Healthy



PitchBook-NVCA Venture Monitor
*As of March 31, 2021

Mega-deals dive further into the mainstream. 167 VC deals at or over $100 million closed in the quarter representing $41.7 billion in capital investment, which puts 2021 on track to easily set a new annual record for mega-deals on both a count and value basis. This also means that 13.5% of the recorded late-stage VC deals in Q1 fall under this category, demonstrating how these transactions—considered to be anomalies only a few years ago—have become commonplace.

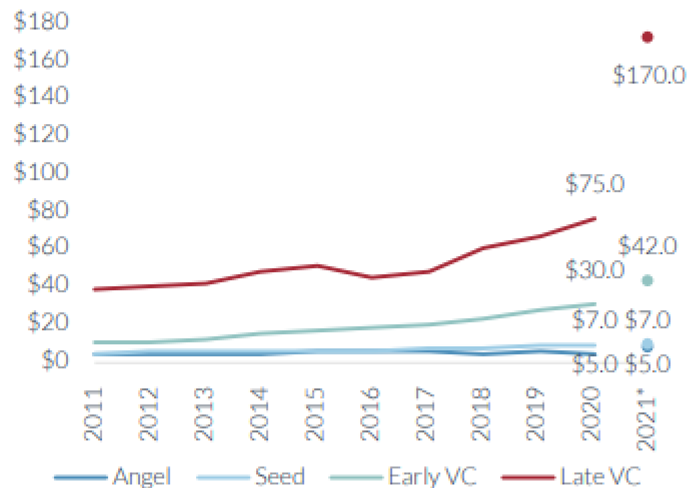
2021 already delivering outlier exits. The largest exit of the quarter came in the form of Roblox's (NYSE: RBLX) direct listing, which valued the business at $41.9 billion. Looking forward in 2021, there are a handful of other multi-billion-dollar direct listings that we expect to close, including the imminent debut of Coinbase, followed perhaps by UiPath or Databricks—both of which we believe raised capital in Q1 to set the stage for a listing later in the year.

VC $$$ to Start-Ups Struggling

Bifurcation of fundraising market persists in Q1. In 2021 thus far, we have seen 13 mega-funds ($500 million+) raised, with billion-dollar funds accounting for 44.8% of all capital raised in Q1. Conversely, only $1.4 billion of capital was raised across 25 funds by first-time VC managers, given the significant challenges that have persisted—especially the suspension of in-person meetings with LPs. For context, seven individual funds raised more than the aggregate first-time fundraising market.

Valuations drive higher at early and late stage on the back of elevated capital availability

US median pre-money valuation ($M) by stage



PitchBook-NVCA Venture Monitor
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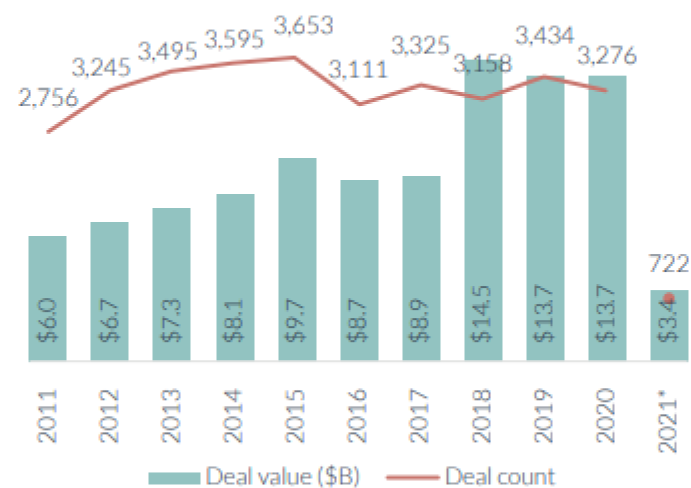
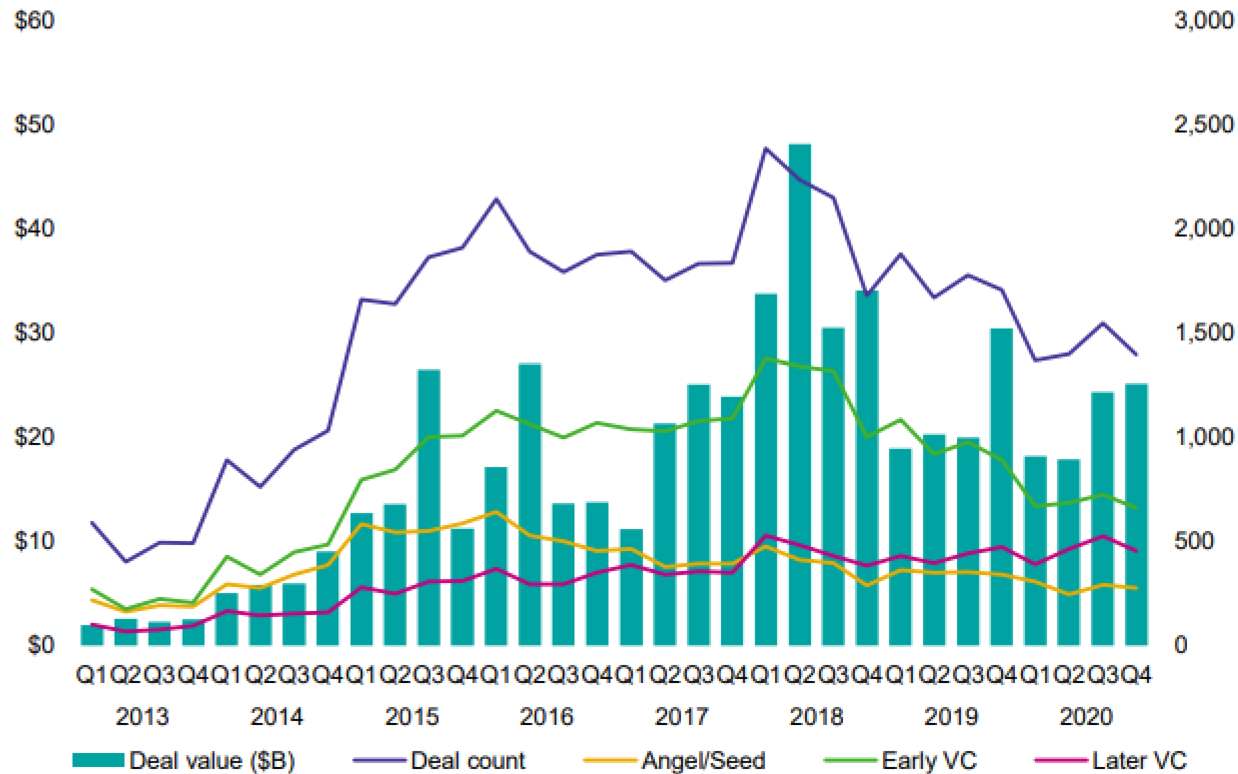
Startups entering VC cycle steady over past few years

US first-financing VC deal activity



PitchBook-NVCA Venture Monitor
*As of March 31, 2021

How is Asia doing?



Source: Venture Pulse, Q4'20, Global Analysis of Venture Funding, KPMG Private Enterprise. Data provided by PitchBook, 1/20/2021.

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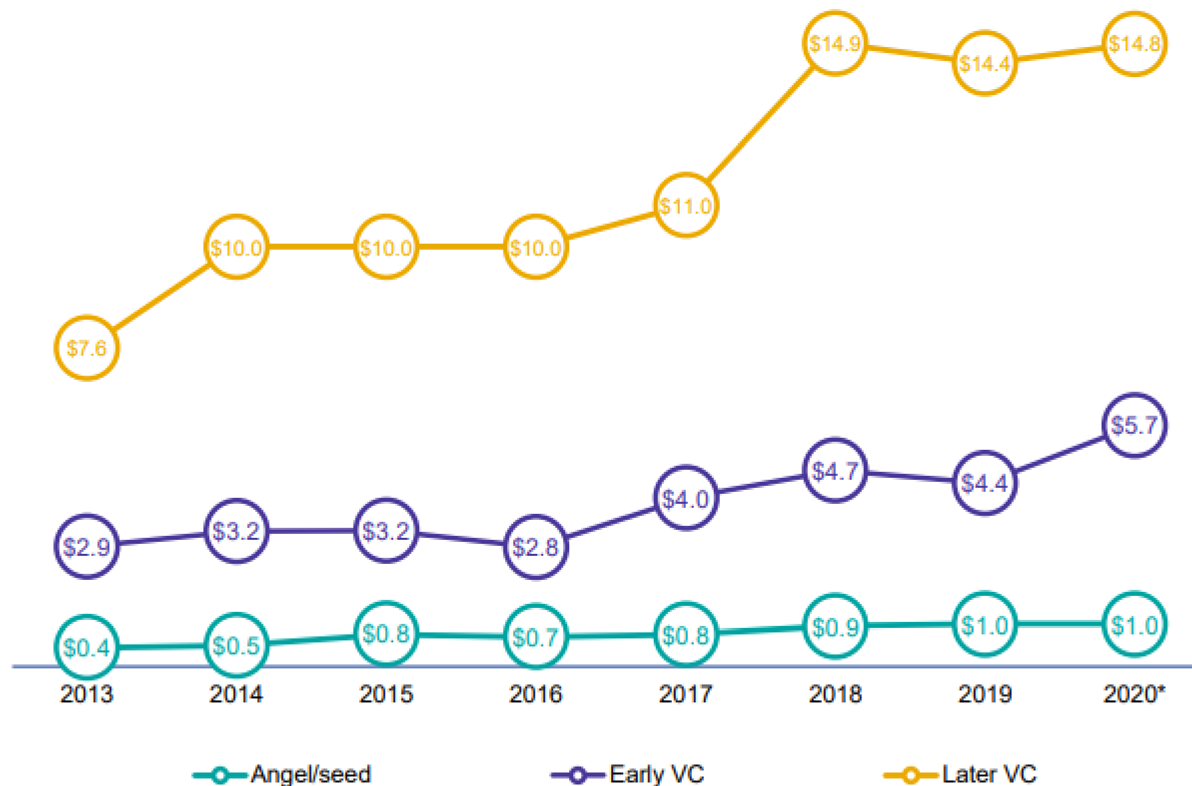
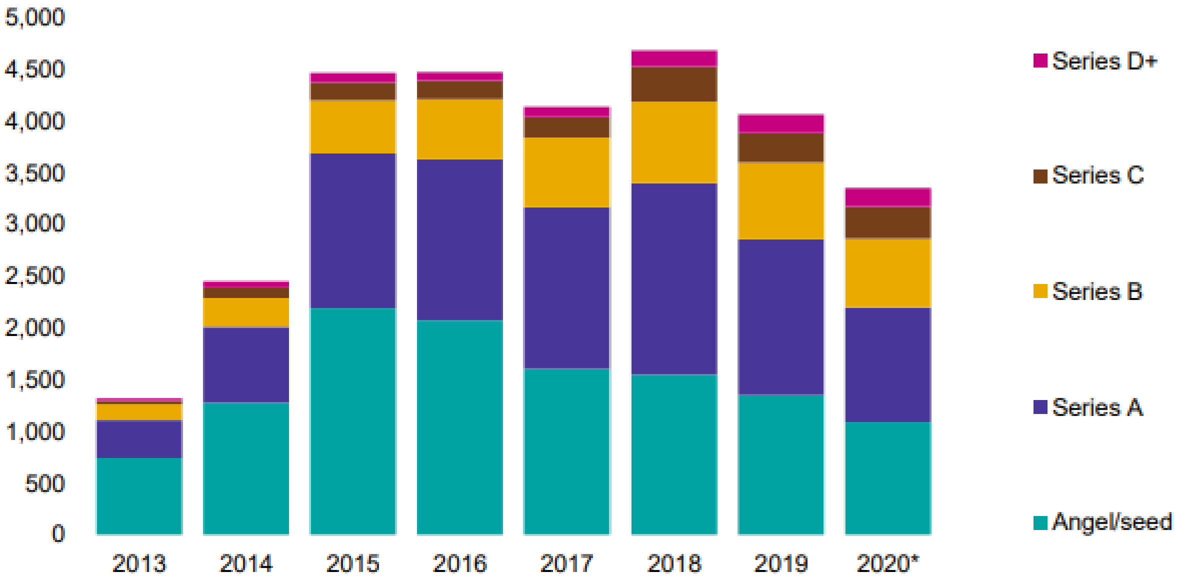
Holding largely steady

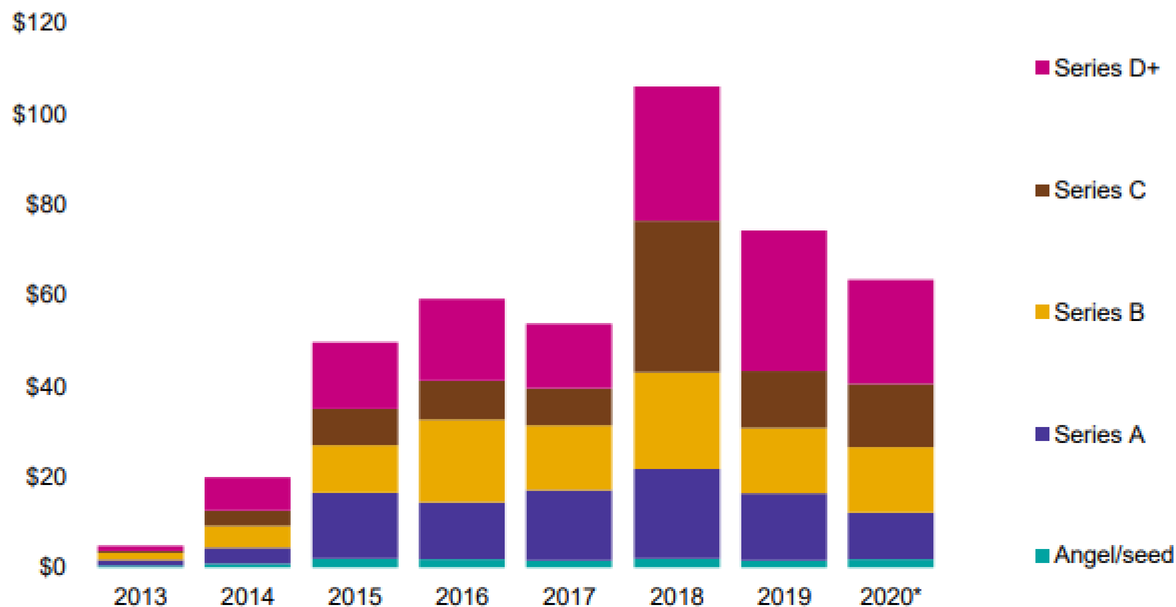


Source: Venture Pulse, Q4'20, Global Analysis of Venture Funding, KPMG Private Enterprise. *As of 12/31/20. Data provided by PitchBook, 1/20/21.

Angel / Seed deals diminishing?



Preference for later stage



Source: Venture Pulse, Q4'20, Global Analysis of Venture Funding, KPMG Private Enterprise. *As of 12/31/20. Data provided by PitchBook, 1/20/21.

Structuring a VC Investment: Staged Financing
Creating Alignment Between Entrepreneur and Investor

How does the entrepreneur raise money?

The 7-minute pitch template?

1. Elevator pitch: the ability to explain the service clearly in 60 seconds
2. The customer: value and benefit
3. The market potential
4. How do you stay ahead of the competition?
5. Marketing and sales approach
6. The core team
7. Key figures, KPIs & finance
8. Roadmap & current status

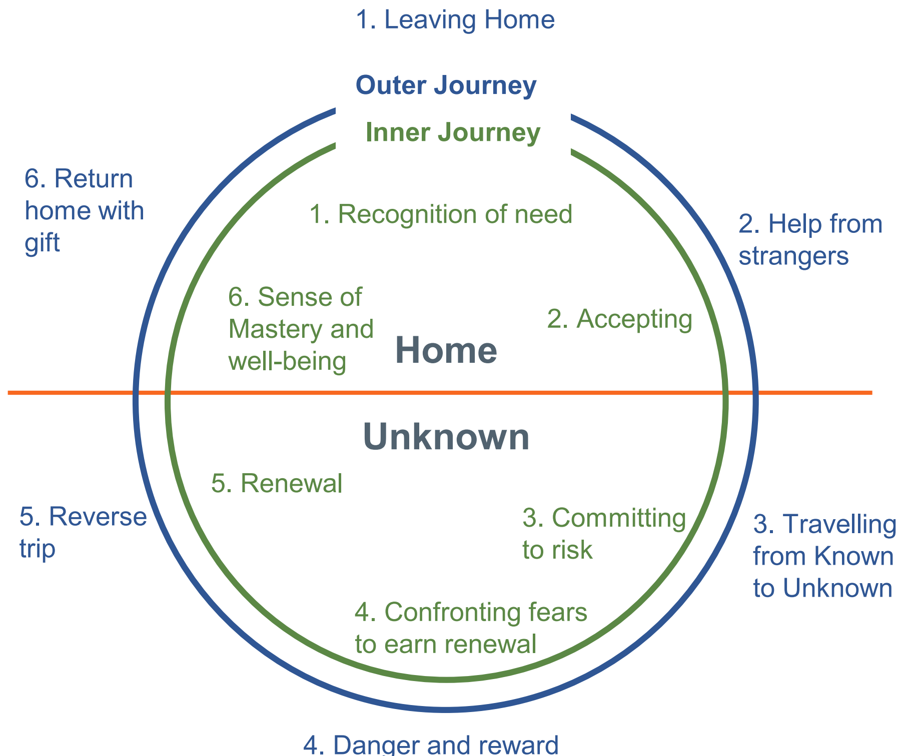
Want my money, tell me a story

- Humans love stories
- Experiencing character-driven stories
  - Engages more of the brain in activity
  - Results in oxytocin synthesis, which activates empathy
    - when the brain synthesizes oxytocin, people are more trustworthy, generous, charitable, and compassionate
  - Promotes understanding of points made
  - Promotes better recall of those points later
- Storytelling and fundraising are both about empathy
- Stories you tell cannot focus only on money
- "*The value of stories in business*" Prof. Aswath Damodaran https://www.youtube.com/watch?v=uH-ffKIgb38

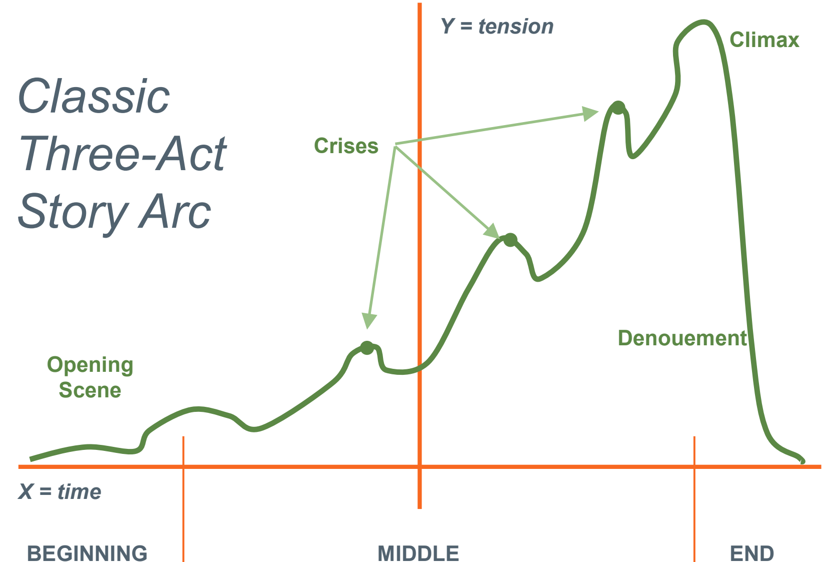
The hero's journey: how to tell your company's story and make it interesting

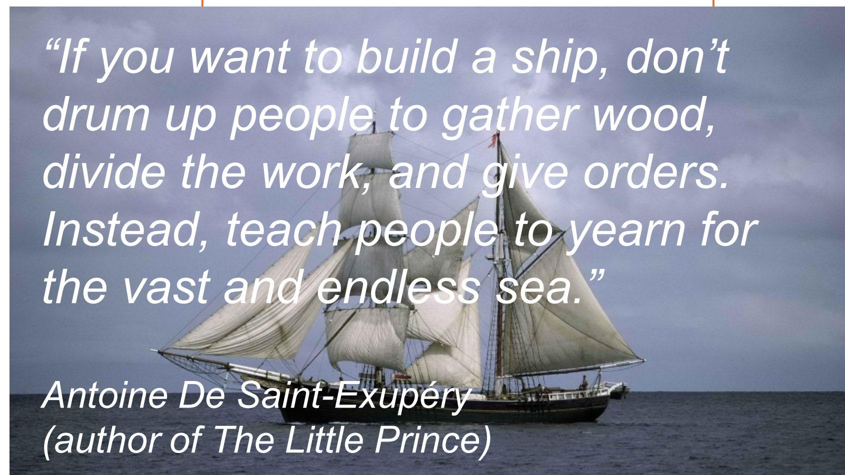
THE HERO'S JOURNEY ACCORDING TO JOSEPH CAMPBELL - VIDEO BY MATTHEW WINKLER AND KIRILL YERETSKY - YOUTUBE

"Pursuit of opportunity without regard to resources currently controlled"



"The Hero's Journey," Joseph Campbell





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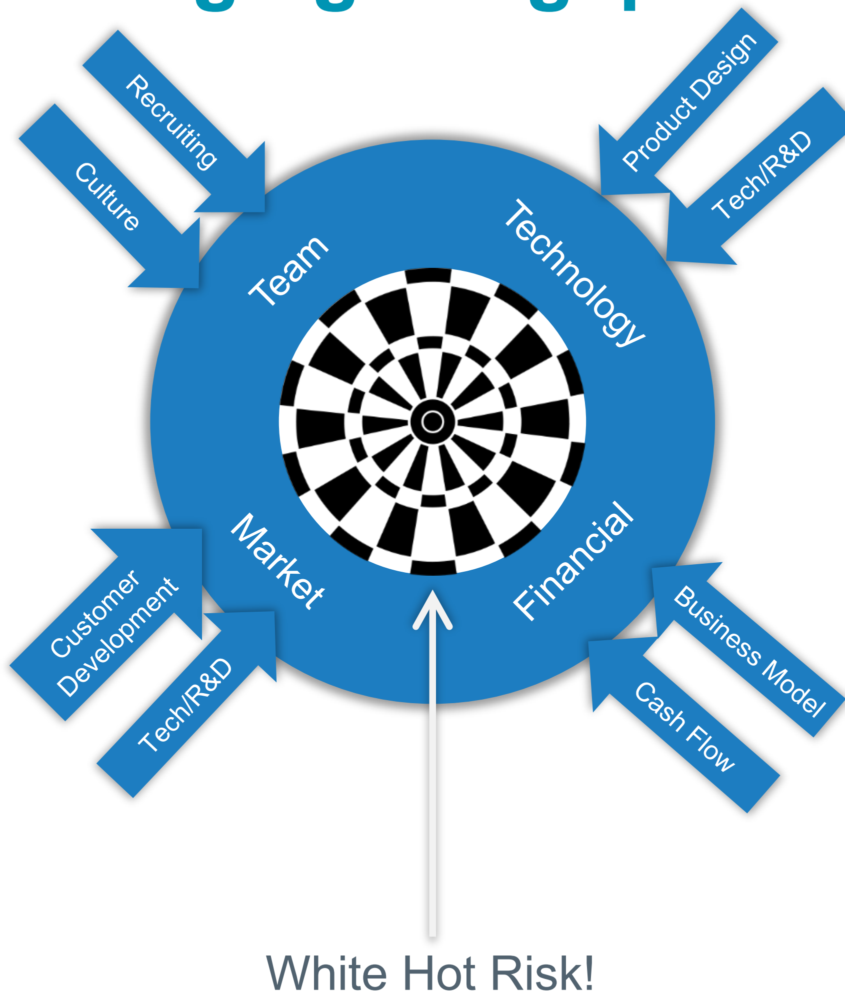
Bridging the gap: risk reduction



- Reducing risk usually requires:
  - Some **type of outside capital**
  - From some **type of investor**
- Changing the capital structure, shareholder base, and board inherently creates new risks.
- The goal in choosing capital sources and structures is to **maximize alignment** between entrepreneurial team and investors, in order to maximize associate risk

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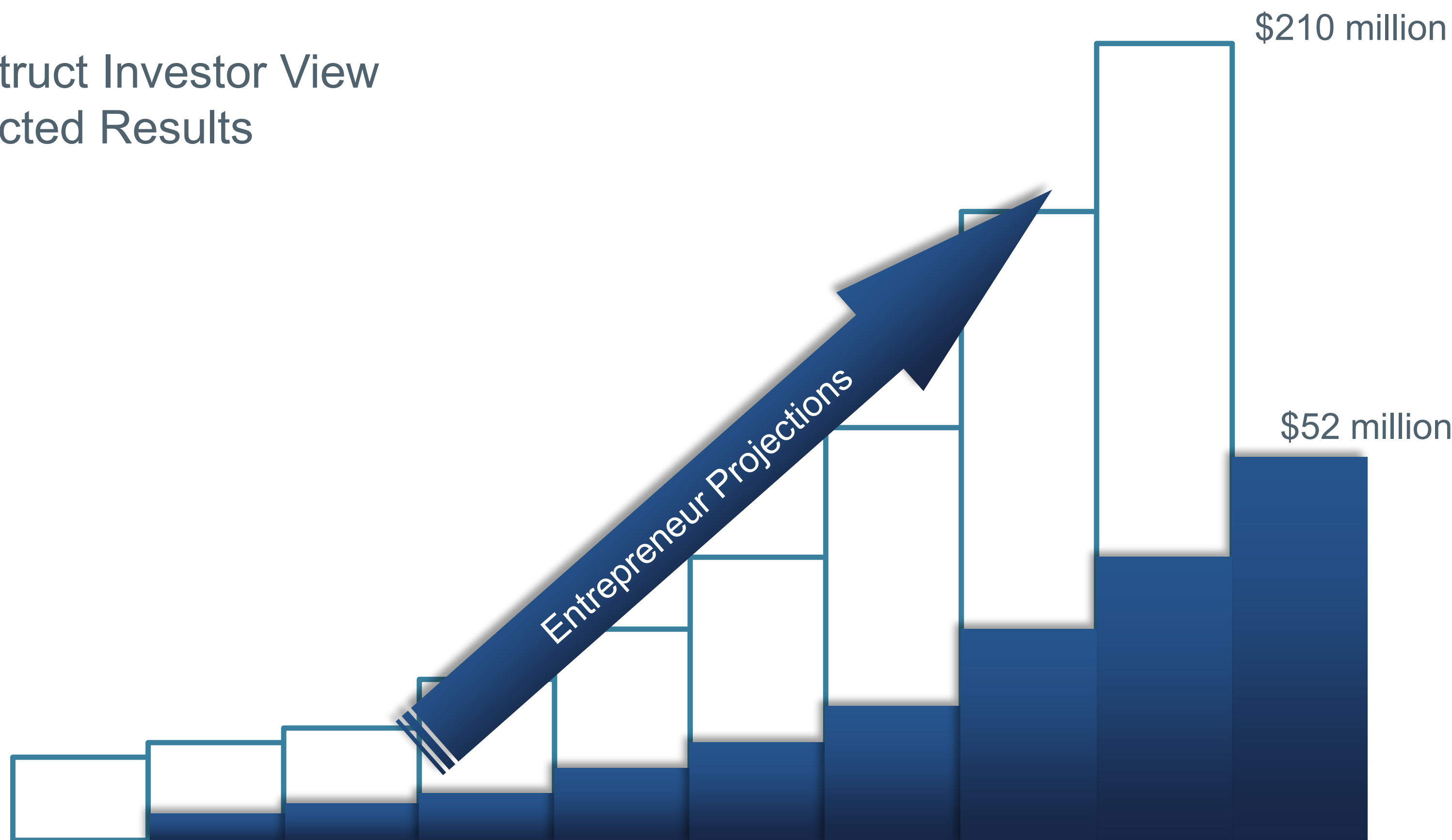
How VCs think: structuring investments for staged risk reduction

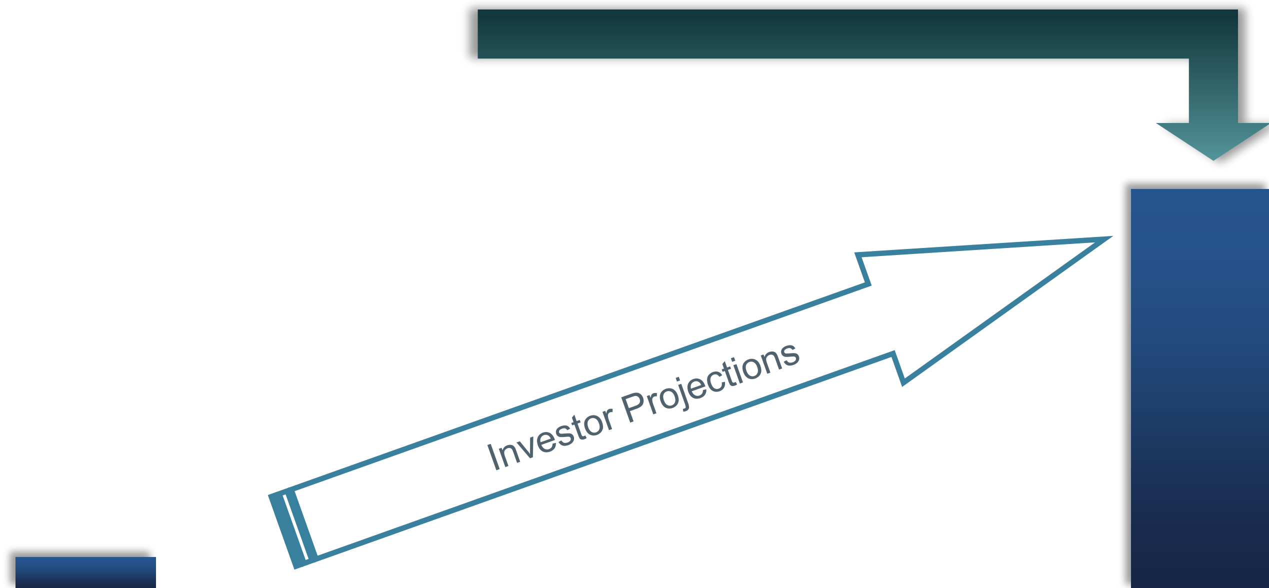
1. Construct Investor View
of Projected Results



Structuring investments for staged risk reduction

2. Assess Likely Status at a Successful Outcome

- $52 million revenue
- 14 million paid users
- 28% EBITA
- 14% net income
- 12 patents
- 3 exclusive worldwide distribution partners

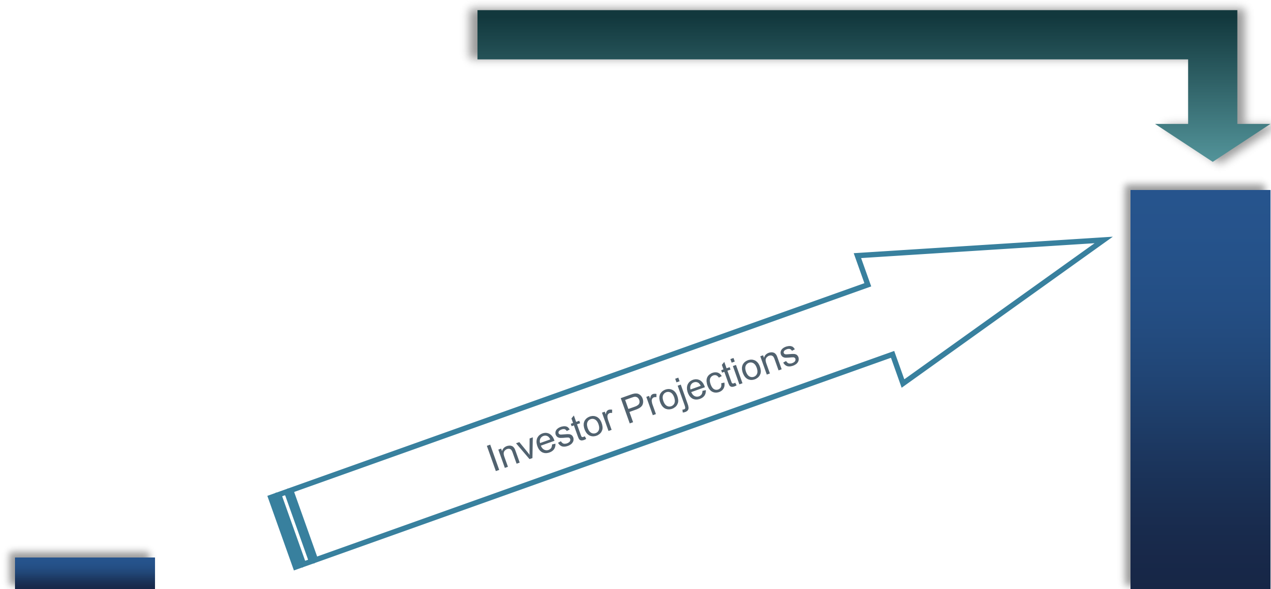


Structuring investments for staged risk reduction

3. Estimate potential value of the company at liquidity/exit based on milestones in prior step

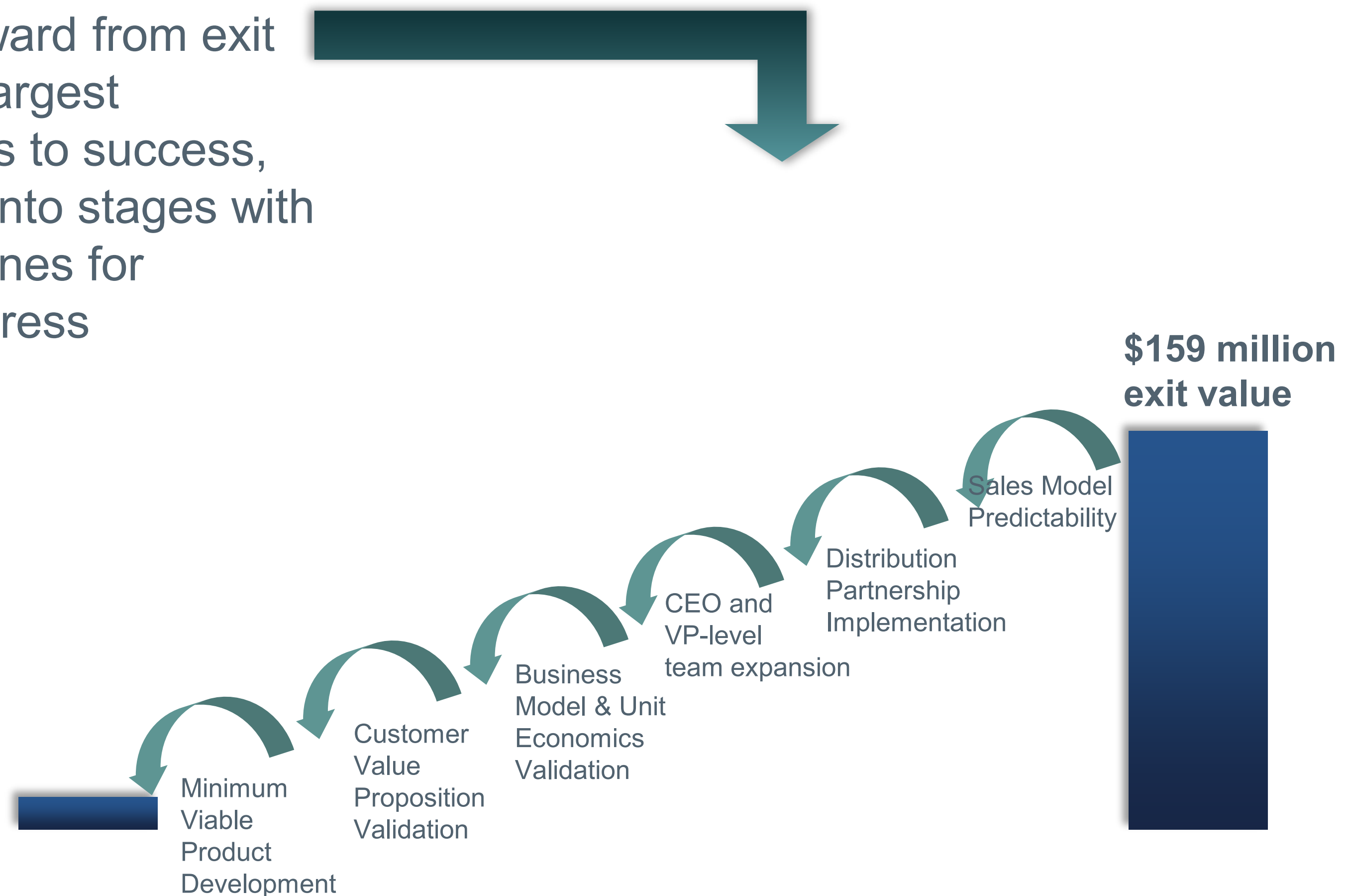
- 3.5X revenue = $182 million
- $20/user = $280 million
- 9x EBITA = $131 million
- 24x P/E = $175 million

Probable value range - $131-280 million
Average = <u>$159 million</u>
Median = $179 million



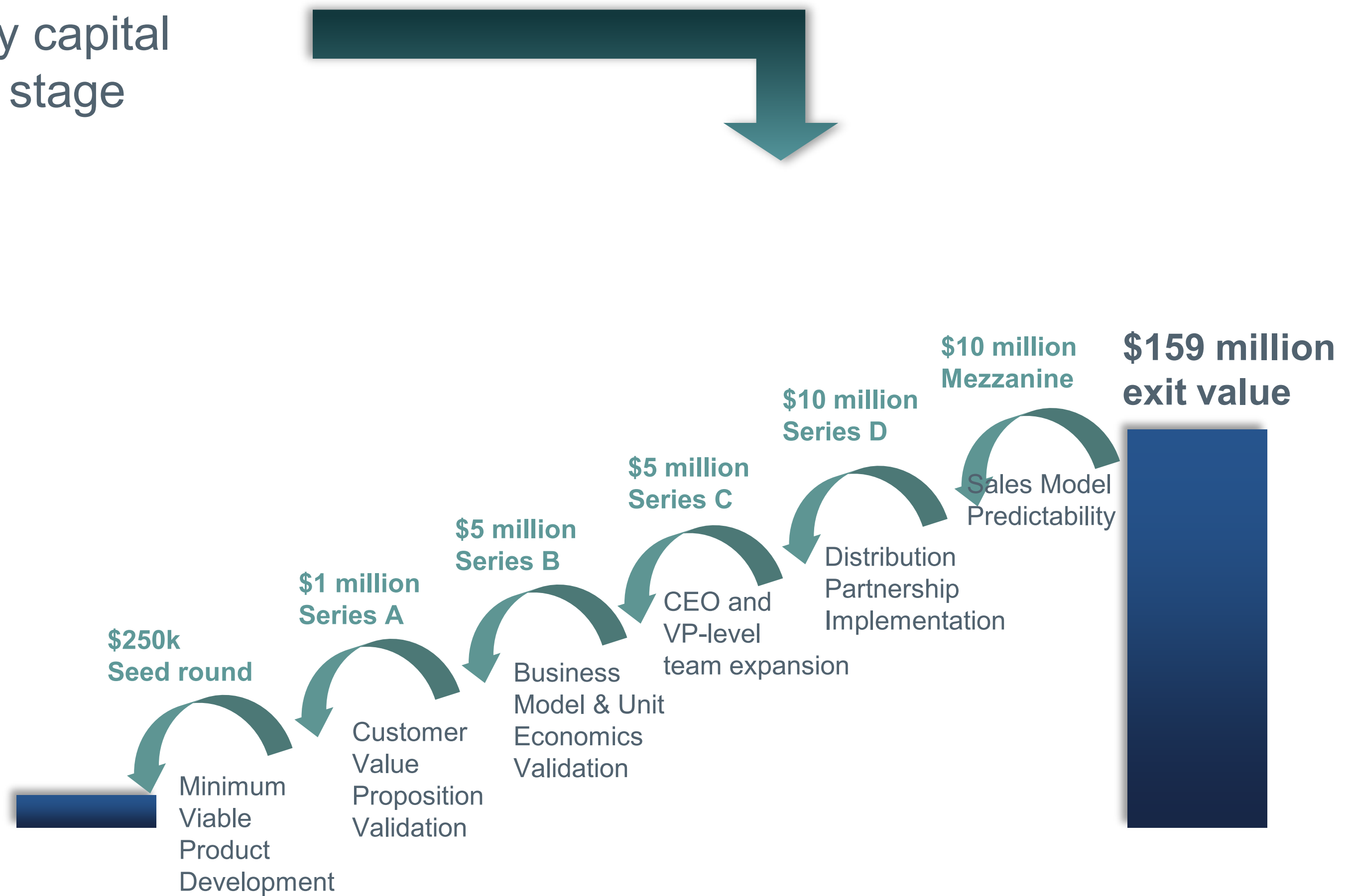
Structuring investments for staged risk reduction

4. Work backward from exit to determine largest perceived risks to success, and organize into stages with logical milestones for company progress



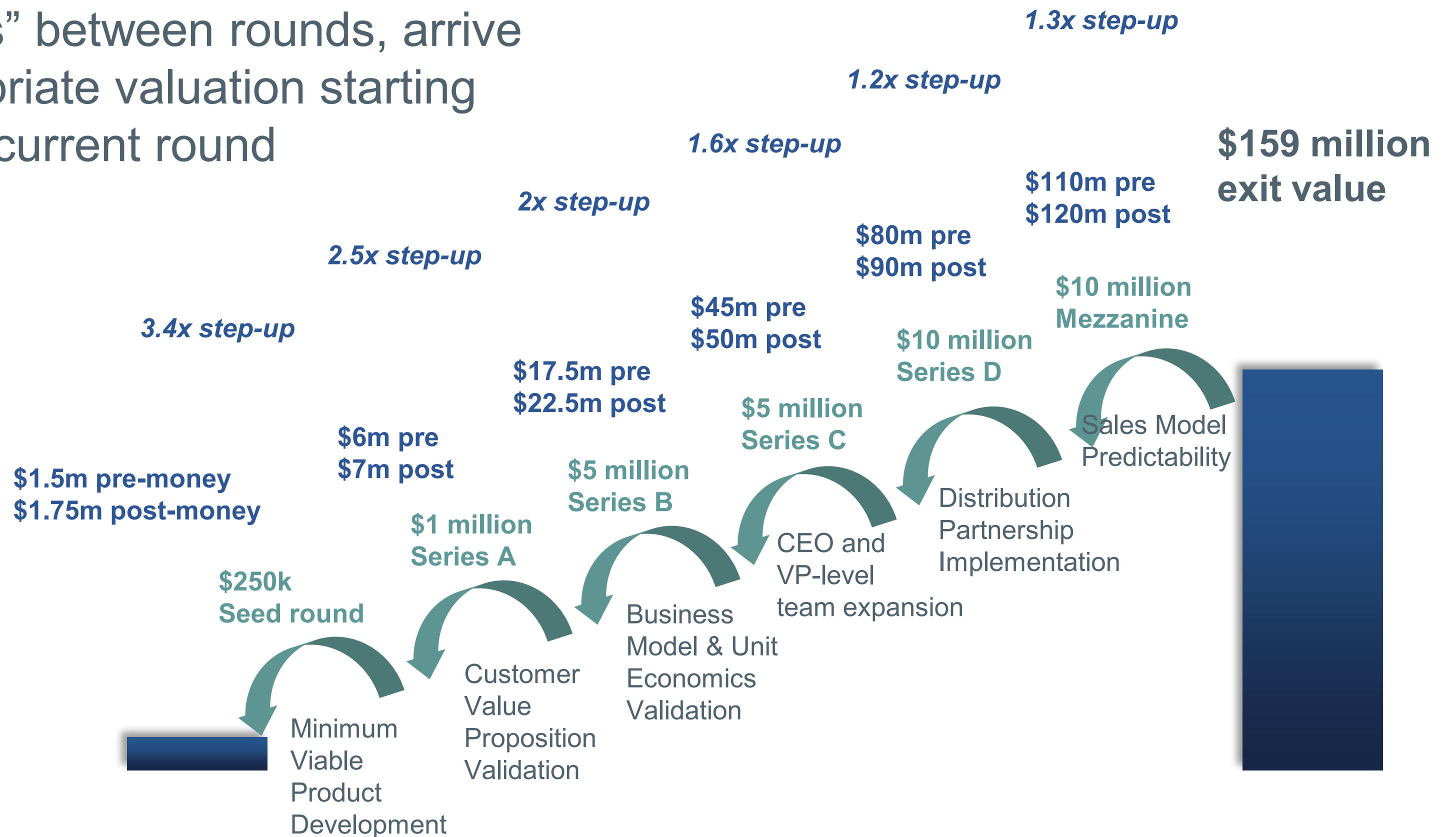
Structuring investments for staged risk reduction

5. Assess likely capital needs at each stage

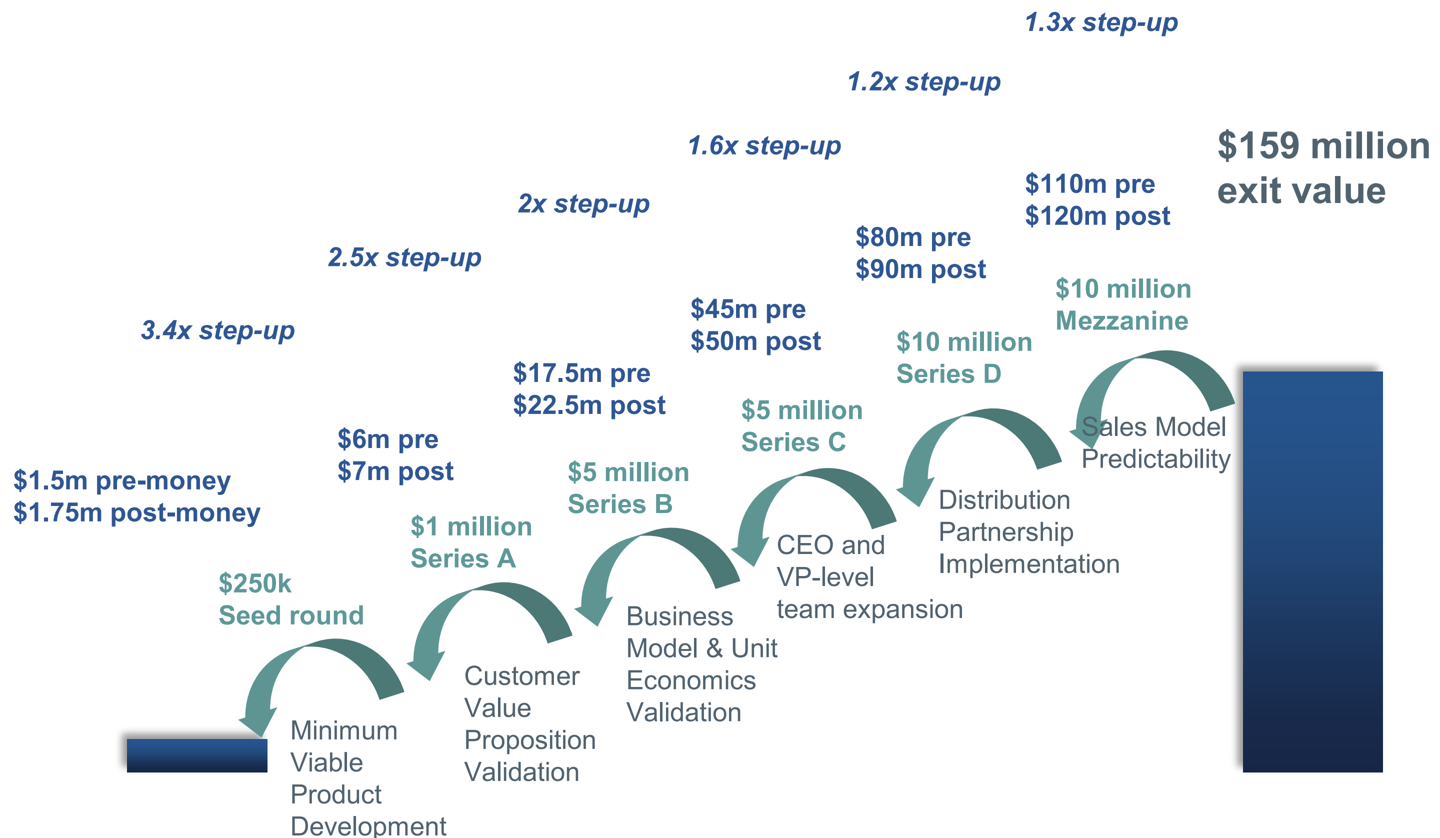


Structuring investments for staged risk reduction

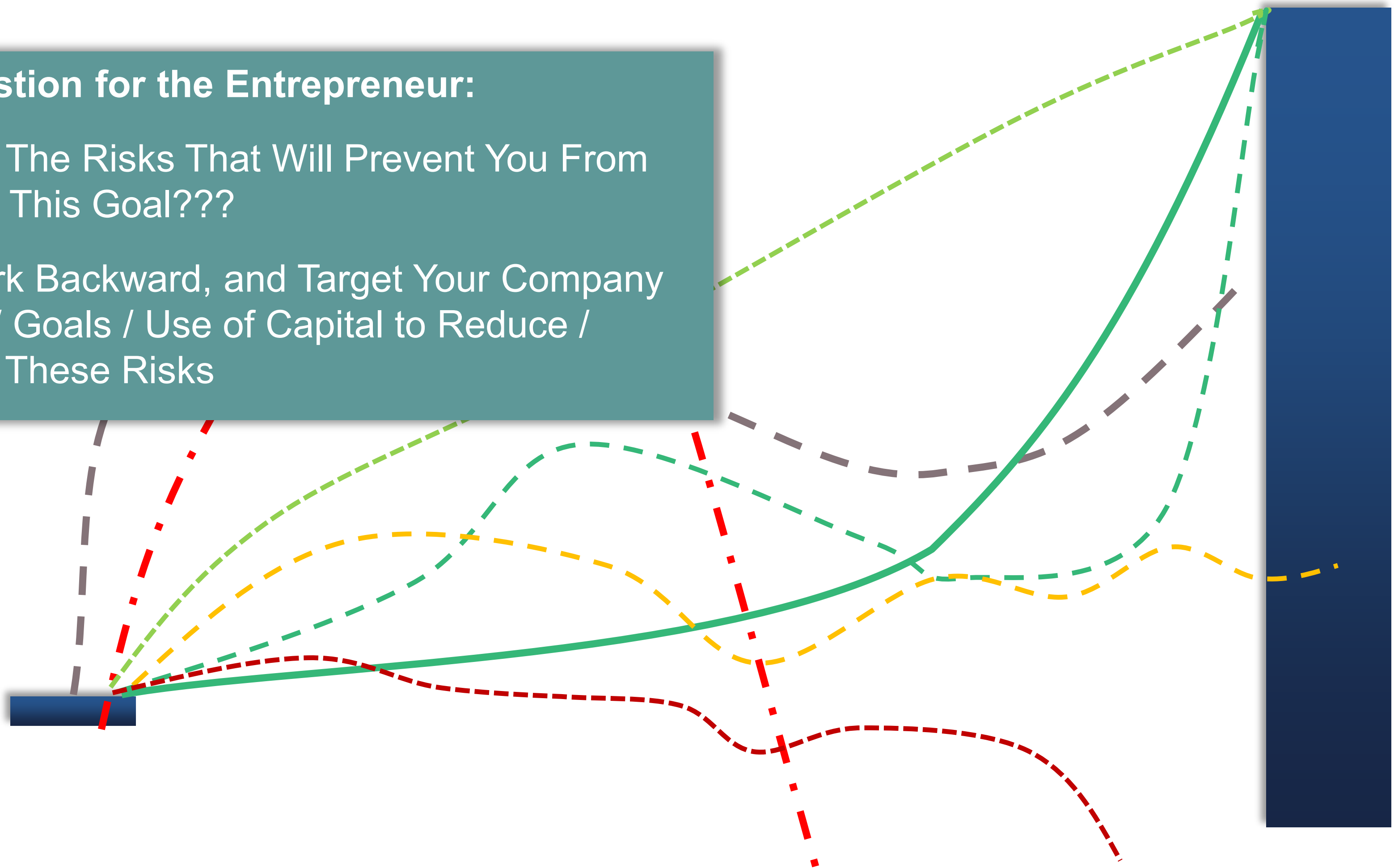
6. Assuming realistic valuation "step-ups" between rounds, arrive at appropriate valuation starting point for current round



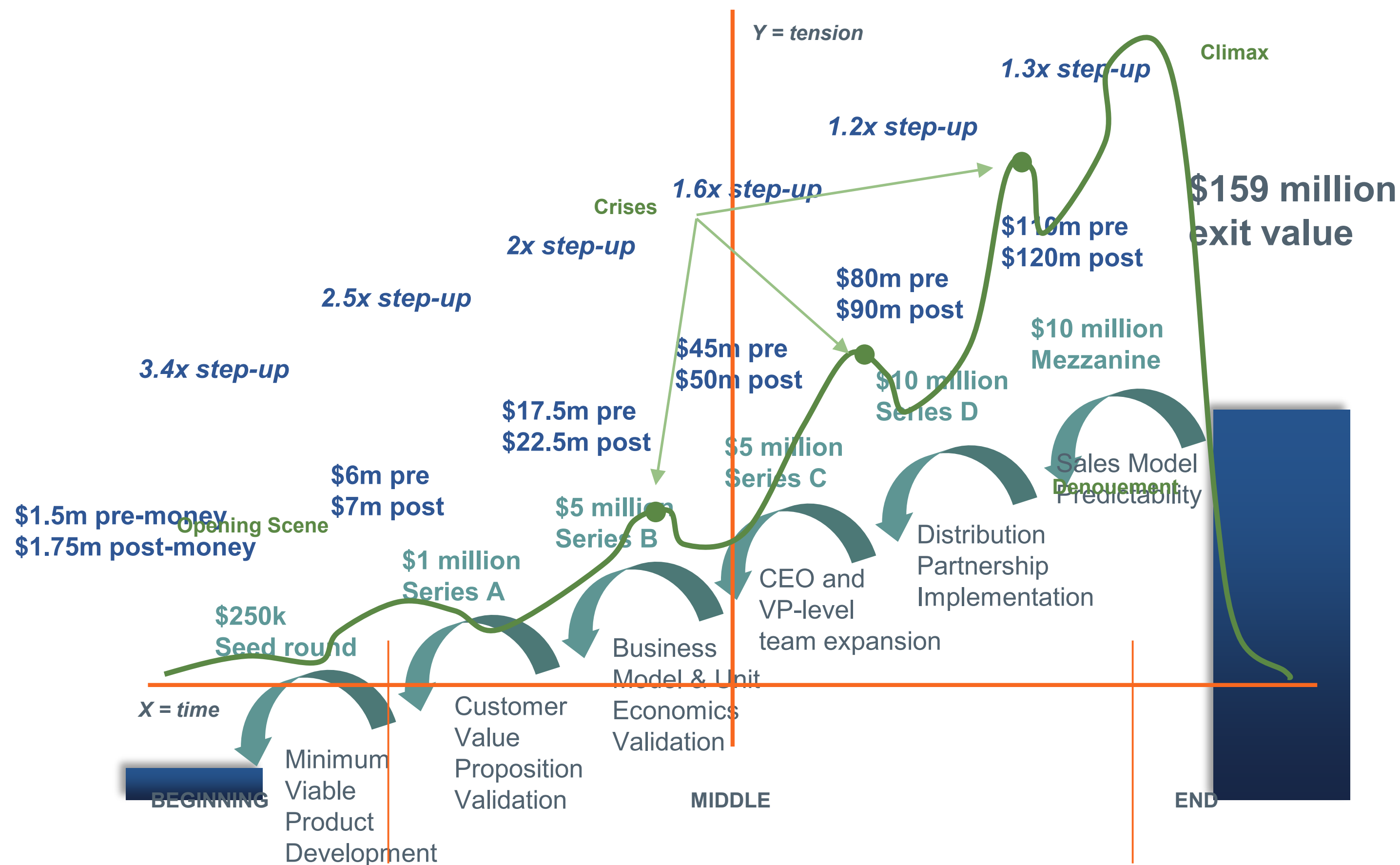
✓ This is "staged" financing



Staged financing allows for multiple "stories" to play out



Staged financing as storytelling



Anatomy of a Term Sheet
AKA Entrepreneur-Investor “Pre-Nuptial
Agreement”

Contrat de mariage en Italie.
Date de création/fabrication : 2e quart du XIXe siècle (1831)

Getting started – Where to start

It's better to hear the ugly truth, than a beautiful lie

Why investors don't want to invest in your deal!

- **Investors never have to invest in a deal**
- Most investors look for a reason to say "no"
  - "your opportunity does not meet our investment criteria"
  - "Our plate is full right now, so we can't devote the time to your plan it deserves"
  - "we might be interested in co-investing when you get a lead investor"
  - "Our funding isn't secure yet for Fund III"
- There's always another deal coming

Image credit: Pixabay.com (Member: Tumisu)

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Should you accept money from an angel?

- AINs becoming more popular while dedicated VC funds remain small
- VCs tend to stick to financial investment profiles; angels more flexible and tend to have non-financial drivers

Show me the money—Investment Capacity

https://www.spf.org/en/global-data/user47/AIreportd.pdf

Angel Investors mobilize their personal wealth, in contrast to more institutional investors like VCs who raise and deploy funds from limited partners (LPs). Due to the significant risks associated with pre-seed and seed stages, Angel Investors in SEA rarely invest sums larger than USD 500,000, which are more akin to VCs who enter the market in subsequent rounds. The average ticket size seems to be around USD 100k for the growing and mature markets, and USD 25k for emerging ones.

Informal Investor		Formal Investor
Founders, Friends & Family or Love Money	Angel Investors	Institutional Investors, Venture Capital Funds and Impact Investors
Ticket Sizes: USD 10,000 -USD 25,000	Ticket Sizes: USD 25,000 - USD 200,000	Ticket Sizes: USD 100,000 and above (some case of USD 50,000 ticket size from certain VC in emerging markets)
Pre-Seed Stage	Seed Stage	Seed and Later Stage

Financing Gap

Angel Investing Parameters

- Angels aim to take 20% ~ 50%
- But, you start with valuation
- Company with pre-money valuation of $2.5M; angel invests $0.75. What is post-money valuation?
- What valuation methodology is appropriate? DCF? Gordon Growth Model? Most valuations derive from trying to back into the exit value?
- Is angel capital appropriate for every kind of industry?
- Discounted valuation from the next round?

"The discounted cash flow method is difficult to use when there are little to no cash flows," – Catherine Mott of BlueTree Allied Angels.

"Factors that affect valuation include management experience, the size of the opportunity/addressable market, size of the round, intellectual property or other barriers to entry, need for future rounds, industry comparables and exit opportunities," – Stephanie Hanbury-Brown of Golden Seeds.

Terminal Value = (FCF x (1+g) / (d – g))

Where:

FCF = Free cash flow from the last forecasted period
g = Stable growth rate
d = discount rate (WACC or required rate of return)

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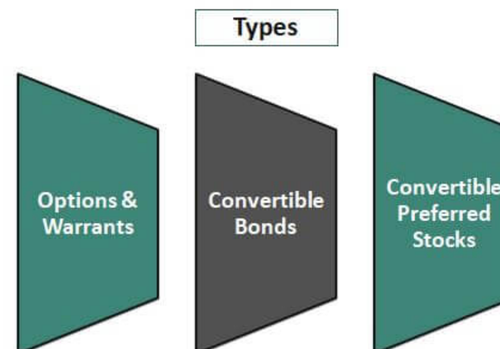
Who gets what? Securities distribution of early stage companies

Sources of Capital

- Lenders
- Angels, VC, Strategic
- Key hires / employees
- Founders

Who gets dilutive securities?

- Warrants
- Preferred shares / stock
- Restricted stock / options
- Common / ordinary shares



Warning Bells

There are some red flags investors should watch for. Are there any unknown investors? Is the term sheet too complicated or inappropriate for the nature, context and stage of the company? Is the company raising enough money? What's the possibility of dilution?

Red Flags in Deal Negotiation

Entrepreneur

- Under financing
- Impossible milestones
- Limitations of syndication
- Corporate strategic investor?

Investor

- No downside protection
- Unwillingness to report
- Weak board composition & poor approval requirements for board membership
- Corporate strategic investor?

"What's the burn rate and is the company raising enough money to make it to the milestones for the next round? Where will this round of financing get the company to? Will it be something measurable to justify a higher valuation in the next round?" – Bill Moore of LORE Associates

Structuring the Deal—Anatomy of a term sheet

Valuation & Cap Table

Control Terms

Financial Terms

Other Items

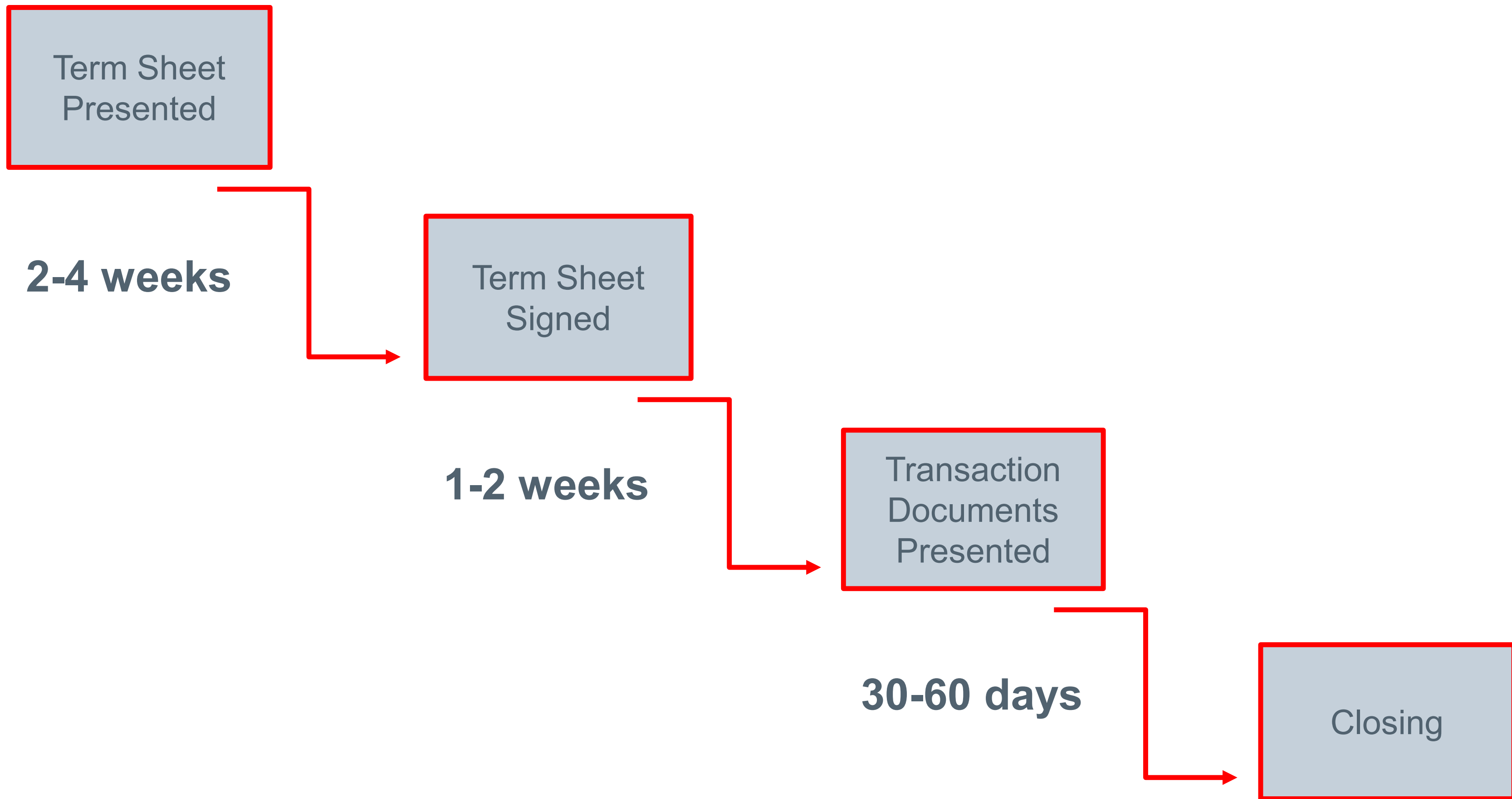
Reference: Robert von Goeben

No words necessary . . . .

Issuing a term sheet

Key term sheet provisions

Valuation & Capitalization	Financial Terms	Control Terms	Other Terms
• "Deal At A Glance" • List of Key Investors • Type of Security Being Purchased • Price of the Security • Investment Amount • Pre-Money & Post-Money Valuation • Pro Forma Cap Table • Required Employee Stock Pool	• Liquidation prefs • Anti-dilution • Dividends • Redemption rights • Registration rights • Founder (re)vesting • Legal costs	• Board composition • BoD selection process • Voting rights • Protective provisions • Investor rights	• Right of First Refusal / Pro Rata Participation • Information Rights • Key-Person Insurance • D&O Insurance • Confidentiality & No Shop • Closing Timeline • Employment, Confidentiality and Invention Assignments for all Employees



*These timelines are examples only and may deviate from deal to deal

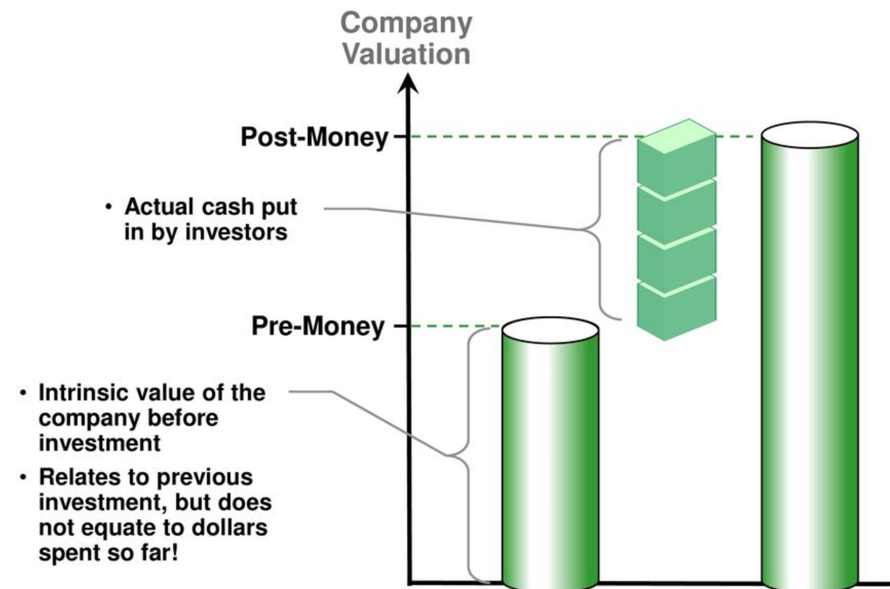
Lawyer’s role in venture deals

- To “translate” complex terms and explain “real” impact
- To expedite pace of transaction
- To help company to build relationship with investors
- To act as bridge between investors and company
- To keep comments on documents to a minimum

Pre-money and post-money valuation

- **What is Pre-money valuation?** Pre-money valuation refers to the value of the Company prior to the investment. It is calculated by multiplying (i) the price per share to be paid by the investors, and (ii) the number of shares outstanding prior to the financing, calculated on a fully-diluted basis so as to include the employee reserve pool. Example: pre-money valuation is $4 million ($1.00 per share times (3 million founders plus 1 million employee reserve shares)).

- **What is Post-money valuation?** Post-money valuation refers to the value of the Company immediately after the financing, and is calculated by adding the amount of the new investment to the pre-money valuation.



Summary of valuation methods—DCF

Discounted Cash Flows

Venture capital firms will often employ a derivative of the discounted cash flows method to value the company. The approach estimates the earnings of the company at a point in the future where an exit is anticipated and then, using the price-to-earnings (P/E) ratio of comparable companies, determines the value of the company at that future point. Then, using a discount rate, the value of the company today is determined. Here are the steps to this valuation approach:

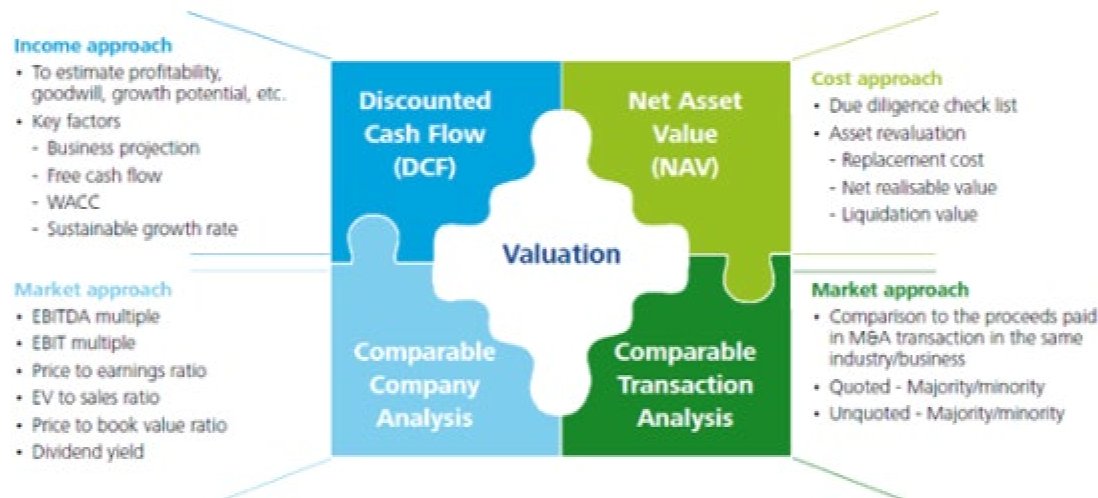
1. Using the financial information provided to the potential investor, estimate the company's net income at the point in the future where the investor will exit the investment.
2. Looking at comparable companies with similar economic characteristics, determine an appropriate P/E ratio.
3. Multiply the P/E ratio with the net income value to determine the value of the company at the expected liquidity event.

$$DCF = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \dots \frac{CF_n}{(1+r)^n}$$

Valuation methods: comparable valuations

Comparison data about similarly-situated companies can provide valuable information on appropriate valuations. While the amount of funding for comparison companies is readily available on a variety of websites, it is more difficult to obtain accurate valuation information. You can also ask your attorney.

Some companies are now providing more specific information such as pre-money valuations.



Valuation methods: comparable exit events

- Another approach that may provide another data point in determining the appropriateness of a valuation figure is looking at exit events of comparable companies. To find comparable companies that have recent merger and acquisition activity, you can look in industry trade press or review local news sources. The Private Equity Hub (PEHub.com) provides news on exit events for venture-funded companies and has feature to search past news stories.

  Thomson, in its database Venture Economics (vx.thomsonib.com), offers a paid subscription service tracking venture-funded merger and acquisition activity.

The "Pref"

- **Perception of the VC Investor:**
  - When the Investor Writes the Check he has done most **EVERYTHING** he promised
  - The Entrepreneur Has Done **NOTHING YET**
- Result:
  - The VC wants its money to be paid back **BEFORE** the Entrepreneur gets his/her return.
- Instrument: **CONVERTIBLE PREFERRED STOCK**

What is a liquidation preference?

- Usually referred to as "Liq Prefs" – nearly all VC financings have Liq Pref, but there will often be negotiation around how the pref works
- Provide preferred shareholders with rights to get their invested capital back ahead of other shareholders
- **Many flavors**, but key aspects are:
  - Multiple: 1x, 1.5x, 2x, etc.: Get this multiple of your $ back first
  - Non-participating vs. participating: "OR" versus "AND"
  - Full vs. capped participation
- KEY IDEA: liquidation preferences alter the "payout" or "waterfall" away from simple division of proceeds based on ownership percentage
- Liq Pref is typically most important economic right of preferred shares (and the major reason why pref shares are usually valued 10:1 over common)
- Liq pref is not relevant to public exits because IPO auto-converts all preferred shareholders into common shareholders

What the liquidity preference looks like in your legal docs

"In the event of any Liquidation Event, either voluntary or involuntary, the holders of each series of Preferred Stock will be entitled to receive out of the proceeds or assets of this corporation available for distribution to its shareholders (the "*Proceeds*"), **prior and in preference** to any distribution of the Proceeds to the holders of Common Stock…"

Liquidation preferences

- A liquidation preference gives the VC investor a “first right” to any proceeds available to shareholders in the event of a liquidation or trade sale of the company. Although a liquidation preference provides the VC investor with downside protection by giving them the first money out of the company that is paid to shareholders, it can also significantly increase the upside to an investment.
- A non-participating liquidation preference means the preferred shareholders can get their investment back upon a trade sale or liquidation of the company, with the balance of the proceeds going to the holders of ordinary shares. If the ordinary shareholders would get more per share than the preferred shareholders under this approach, the preferred shareholders can voluntarily convert their preference shares into ordinary shares and share pro rata in the proceeds.
- Most VC investments include a participating liquidation preference that permits the VC to receive their money back first in a trade sale or liquidation of the company, with the balance of the proceeds being divided amongst the holders of ordinary shares and preferred shares on a share-for-share basis. The participating preference is often referred to as a “double dip” because the VC investor receives their money back and then gets a share of the remaining proceeds.

When does a liquidation preference come into play?

A liquidation preference comes into play in one of two situations:

1. the company fails and has to sell the remaining assets and liquidate the business, or
2. the company is acquired by or sold to another company (or also a merger transaction where the current shareholders wind up no longer owning the company).

In each of these cases, the shares will end up liquidated and need to determine how to divide the proceeds from the transactions. The liquidation preference for the investors ensures that the investors are the shareholders that will be paid back first, allowing the investor to recoup their initial investment (and perhaps more). Then, after the preference is paid, any proceeds that remain will be allocated proportionally to the common stockholders.

Case study: how the liquidation preference works

Company A raises $6 million on a $6 million pre-money valuation for a post-money valuation of $12 million. Now the founders of Company A own 50% of the company and the investors own the other 50% in preferred stock. One year after the financing, an offer is made by a third-party to buy the company for $10 million. In this simple example (**and absent any liquidation preference**), the founders would get $5 million of the proceeds (50% of $10 million) and the investors would get the other $5 million.

Do you see the problem here?

On this transaction, the investor just lost $1 million, while the founders just made $5 million. That's not a great business model, is it?

So to prevent this from occurring, the investor will require a liquidation preference. This insures that the Series A investors get paid back first - their full $6 million investment - before anyone else gets paid.

What is a pref multiple? And how does it work?

In some cases, the liq pref may be greater than 1x - sometimes 2x or 3x. This is referred to as a preference multiple. In this case, in the event of a sale or liquidation of the company, the investor will first receive 2x or 3x its initial investment before the remaining funds are distributed.

CASE STUDY:

A 1x liquidation preference means that if you (as a venture capitalist) have invested $1 million (M) into a company, you must be paid back $1M before any common shareholders are paid anything. If the company was sold for $1.5M, you would be guaranteed at least $1M no mater what your equity ownership is. If this company was sold for $900,000, you would be guaranteed the entire proceeds because $900,000 falls under your guaranteed $1M in liquidation preference. For a 2x multiple, you will be paid back $2M (despite only committing $1M) before common shareholders are paid anything. Multiples are typically 1–2x but depending on market conditions, they can be as high as 10x. **If you are an entrepreneur, you obviously want the lowest possible multiple to have the least amount of proceeds obligated to the investor.**

Another case study

CASE STUDY:

This time, Company A again raises $6 million on a $6 million pre-money valuation for a total valuation of $12 million post-money. The investors have a 3x preference multiple, meaning they would receive $18 million back in a liquidation or sale event, before any other shareholders are paid. One year later, the company receives an offer to buy the company for $20 million. The investors hold a 3x preference on non-participating Preferred Stock. Now, after the liquidation, the investors will receive their $18 million (the initial $6 million investment times 3), leaving $2 million to be allocated among the common stockholders.

Why are preference multiples important? The difference between using a 1x liquidation preference multiple and a 3x preference multiple equates to $8 million of additional proceeds due to the investors on this $20 million transaction ($18 million vs. $10 million if the Preferred converted into common and received 50% of the proceeds).

What is non-participating preferred?

- Under this type, the investor has the option to either 1) **exercise his/her liquidation preference** or 2) **convert their preferred shares** into common equivalent shares (where equity ownership % is derived) and be paid a proportion of the proceeds based on their equity ownership of the company. Typical preferred to common conversion rates are 1 to 1 but one should read terms carefully to avoid getting blindsided by a higher/lower conversion rate.
- To illustrate the *non-participating* type, if you have invested $1M into a company with a 1x *non-participating* liquidation preference in exchange for 20% ownership, and the company was sold for $2M, you will have two payout options. You can exercise your liquidation preference to receive a guaranteed $1M back, or you can choose to convert your preferred shares for $400,000 (20% of $2M). The rational choice would be to obviously exercise the liquidation preference for the higher payout ($1M>$400,000). In this specific example, an exit value of $5M must be achieved for the investor to **be indifferent** between choosing to exercise or convert since the same payout ($1M) would be achieved under both choices. This point of indifference is called the **conversion threshold**. An exit value below the conversion threshold would force an investor to exercise his/her liquidation preference. An exit value above the conversion threshold justifies conversion into common equity.

What is participating preferred stock?

In some transactions, after the Preferred Stock receives their initial liquidation preference (1x, 2x, 3x or more), then they also receive the right to receive a portion of the remaining proceeds. Enter the concept of participating Preferred Stock. In the event of liquidation such as a sale of the company, the liquidation preference ensures that the Preferred Stock is paid back first (or paid back 2x/3x). But (**and here's the kicker**) participating Preferred Stock are then entitled to share (participate) with the common shareholders in the remainder of the proceeds.

Case study: how participating preferred stock works

This time, Company A gets an outstanding offer to sell the company for $20 million just a year after receiving funding. The investors hold participating Preferred Stock. This means that the investors will first receive their $6 million back, leaving $14 million to be allocated. Now, the Preferred will participate based on their ownership (here 50/50) in the remaining amount -- $7 million going to each. So the investors receive $13 million and the founders receive $7 million of the $20 million purchase price. If the investors had held non-participating Preferred Stock, then the investors would have a choice: (a) exercise the liquidation preference and receive only $6 million, or (b) convert the Preferred Stock into Common Stock and take their portion ($10 million).

Why is Participating Preferred Important?

The difference between using participating and non-participating Preferred Stock in the term sheet was $3 million for the investors ($14 million vs. $10 million, and the reason that understanding a liquidation preference matters.

A non-participating preferred effectively requires that the preferred shareholders elect whether to retain their preferred stock and receive only their purchase price, or convert their preferred stock to common stock to share in the proceeds remaining after payment is made to any non-converted preferred stock. Participating Preferred shareholders receive their original purchase price and then participate with the common shareholders in the distribution of the balance of the remaining proceeds.

Double dipping

Think of *participation* as double-dipping into the proceeds pool.

Participating preferred holders will never convert because they will always have a higher value/share than common shareholders since they are adding their guaranteed liquidation preference value **on top** of *participation* (which is the same value as common shares).

Founders should avoid participating liquidation preferences as this will always generate a larger exit value for the investor (thus, smaller for the founder) than *non-participating* liquidation preferences.

Participating is less common than *non-participating* liquidation preferences.

What is capped participating preferred stock?

- Based on the prior examples from the guides of preference multiples and participating preferred stock, it may seem that these terms are unfair. That's not exactly the case. Historically, most venture deals involved a non-participating preferred stock.
- **In recent years**, however, many investors have insisted on a participating preferred to avoid the situation wherein the company is acquired for approximately the post-financing valuation (i.e., there is no appreciation in the value of the company) and
  1. the preferred shareholders receive their invested amount but no return, and
  2. the common shareholders receive a substantial return based on their lower cost basis.

  In negotiating this point, the company would argue that the investors should not expect a return if the company does not appreciate in value and that the investors should not be paid on the front end (the initial preference payment) and the back end (the distribution of the remaining proceeds) if the company is successful.

Growth of capped participating preferred stock

Use of capped participating Preferred has become much more common. With capped participating Preferred, the preferred stock will be participating in mergers where the return to the preferred shareholders would be less than a fixed multiple of the purchase price (typically between three and five times) on a straight pro rata sharing, and non-participating in mergers above that price point.

Capped participating Preferred is meant to reward everyone equally when the company has a very successful sale or merger event. At an acquisition above the “”cap” price, investors would convert their Preferred Stock into Common Stock and share the distributed assets pro rata with all other holders. But, if the event is a medium success, the investors will receive a greater portion of the proceeds.

Case study: how capped participating preferred stock works

Again, Company A gets an outstanding offer after the first year to sell the company for $20 million. As before, the investors hold participating Preferred Stock with a 1x preference multiple, **but this time there is a cap set at 4 times the original purchase price** (often this also includes dividends, but we'll skip that here). So, if the management decided to take this deal, the investors would get $13 million ($6 million from the 1x liquidation preference and then 50% of the remaining $14 million) and the founders would get $7 million (their half of the $14 million after the initial $6 million to the investors). While this would be a nice result, management believes there is more to the company and rejects the merger.

Another case study

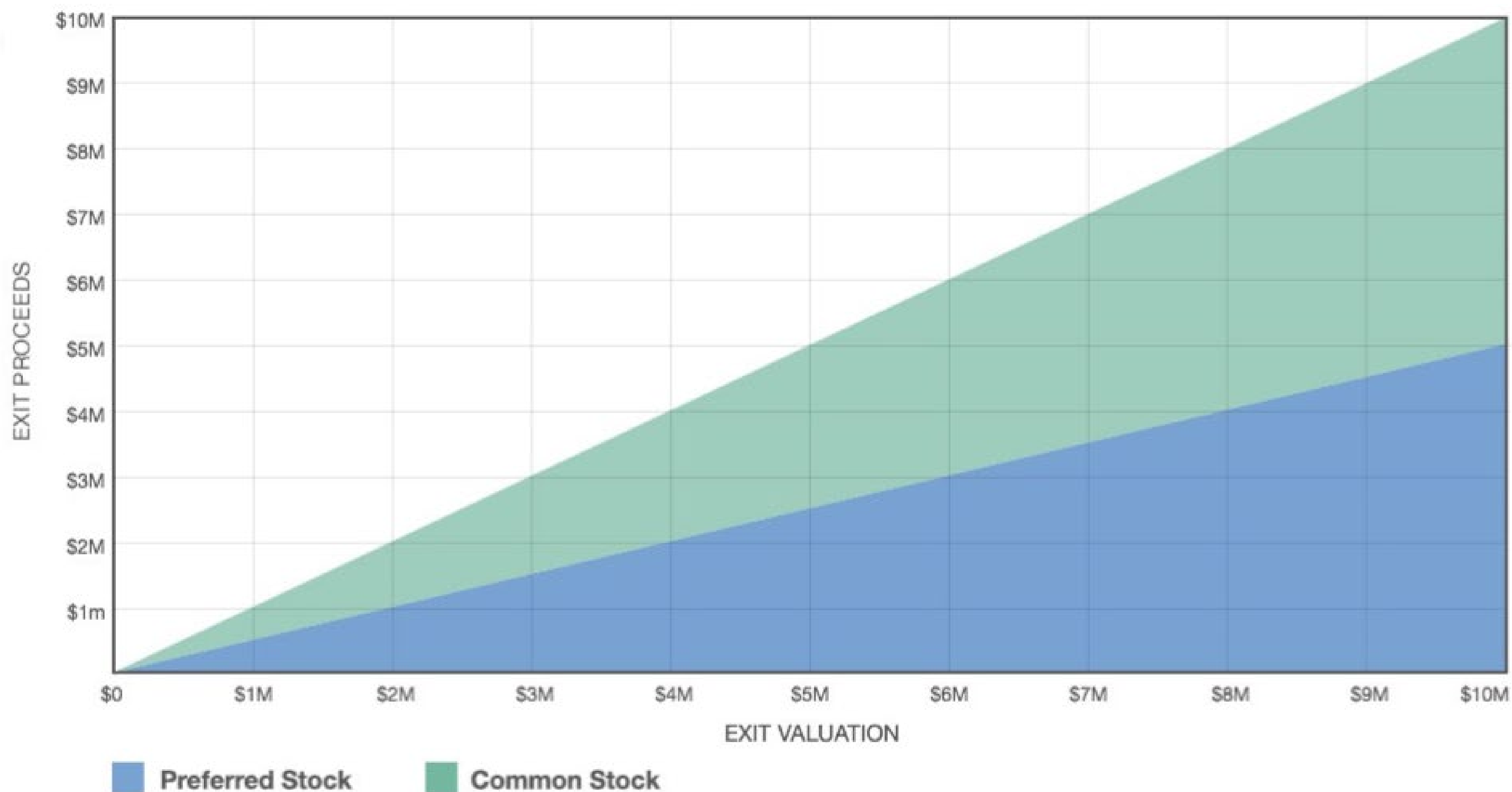
While liquidation preferences were designed to protect investors, *participating* liquidation preferences can create unfair scenarios for the entrepreneur. Caps on the amount of committed capital were introduced to protect the entrepreneur. **These days, payout caps are typically around 3x the investment amount**. An investor committing $1M with 1x *participating* liquidation preference on a 3x cap will receive **up to** $3M in **total proceeds** ($1M liquidation preference + $2M in *participation*) if he/she does not convert. An investor must choose to convert fully to common to receive any payout higher than its cap. Thus, the **cap introduces a conversion threshold for participating preferred shareholders** that otherwise would not exist. Having no cap on participation has an adverse effect on the entrepreneur.

Case study: how capped participating preferred stock works (fast forward 2 years)

Fast-forward to two years later. The company has taken off like a rocket and now receives an offer from a new suitor to purchase the company for $60 million. Because of the cap, the investors now have a choice. They can (a) take $24 million which is 4x their original purchase price and no more, or (b) convert their stock into common and receive $30 million, half of the total proceeds from the sale. Without the cap, the investors would receive $33 million ($6 million from the 1x liquidation preference and then 50% of whatever remains) and the founders $27 million (their half of the $54 remaining after the $6 million from the liquidation preference). Use of the capped participating Preferred may provide for better alignment of priority among the investors and founders.

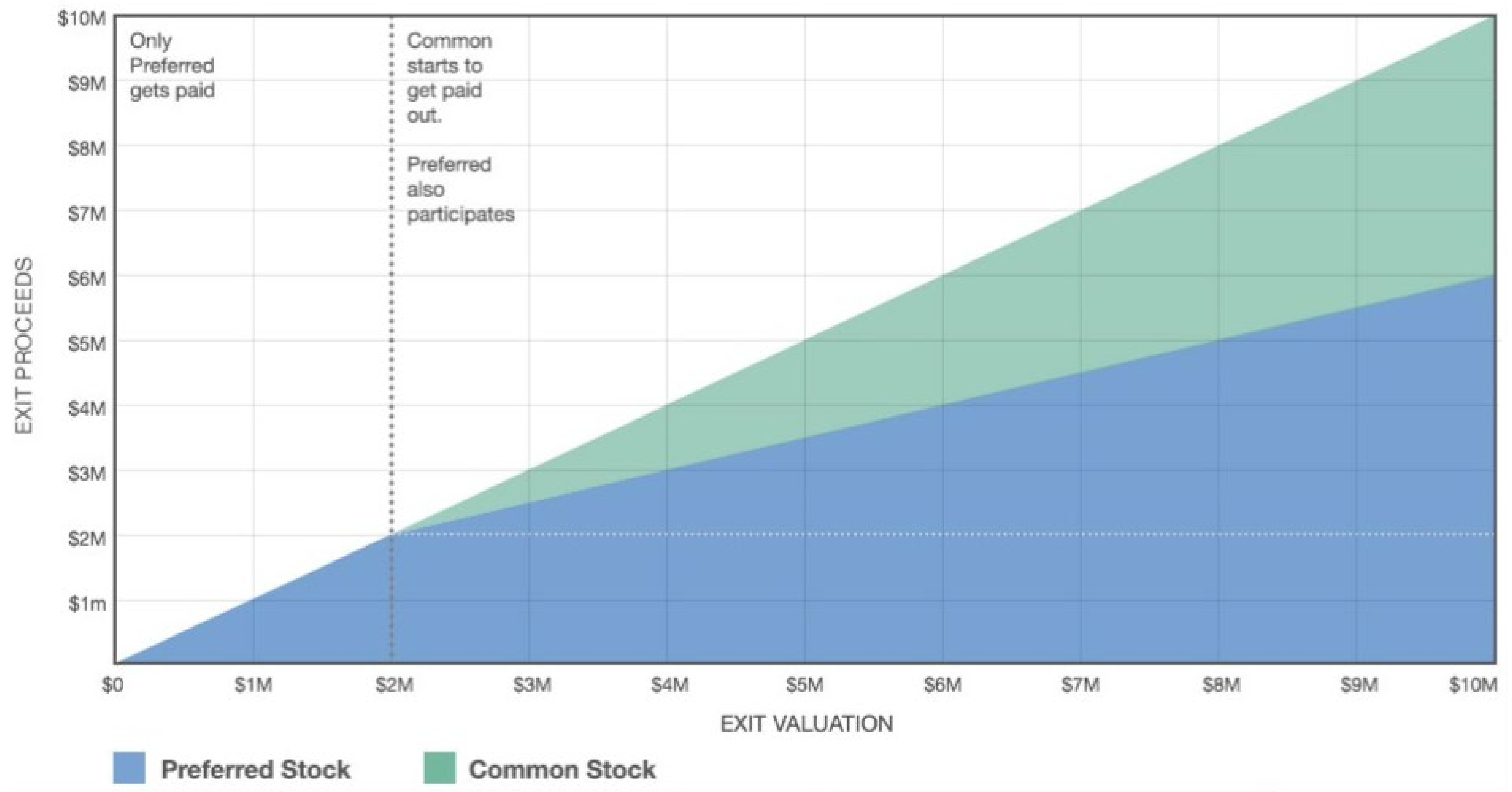
No liquidation preferences—an equal split

https://tools.ltse.com/funding-your-startup-a-founders-guide-to-liquidation-preferences-e7db39469463



1x preference, participating

https://tools.ltse.com/funding-your-startup-a-founders-guide-to-liquidation-preferences-e7db39469463



1x preference, non-participating

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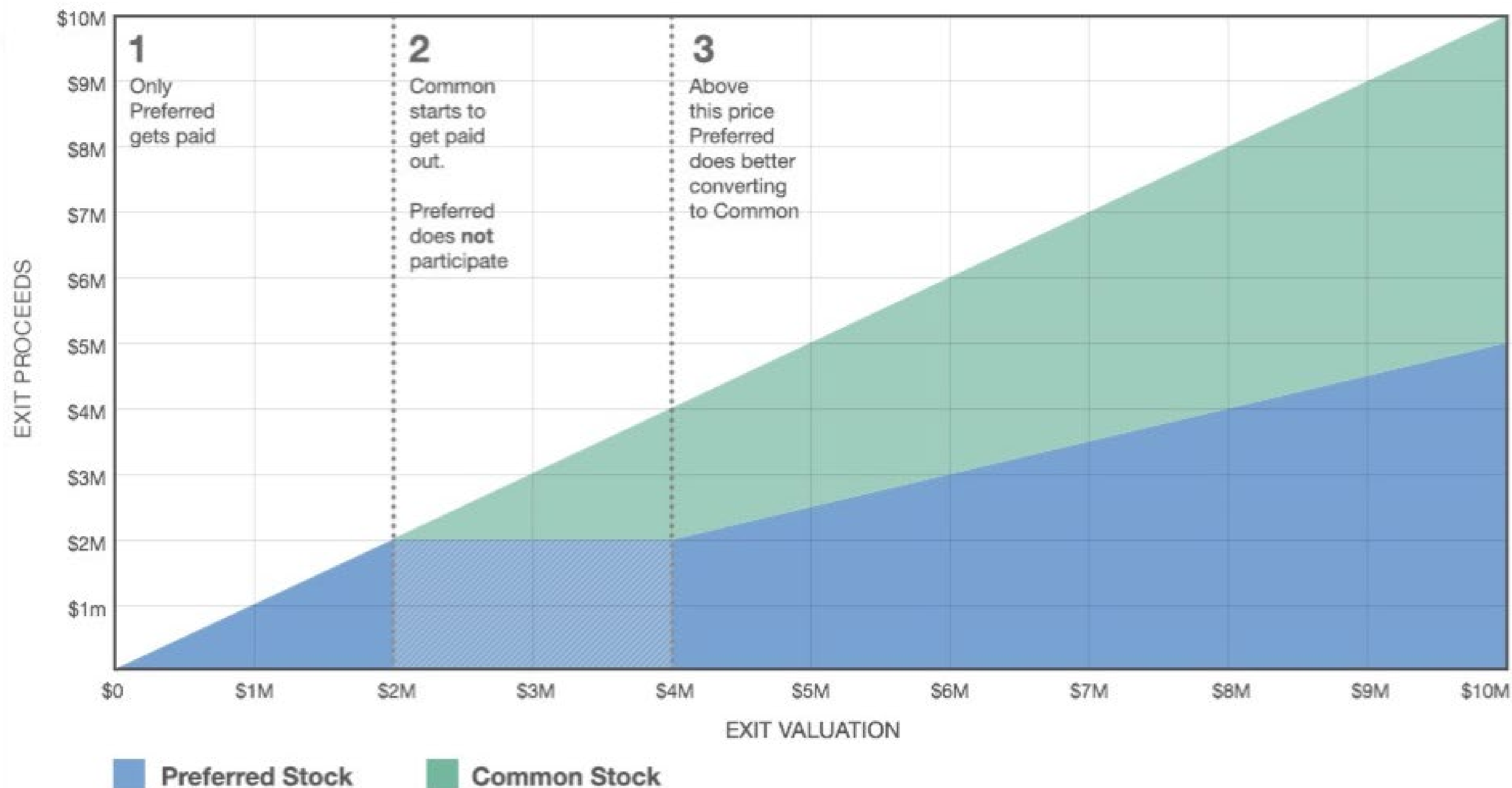
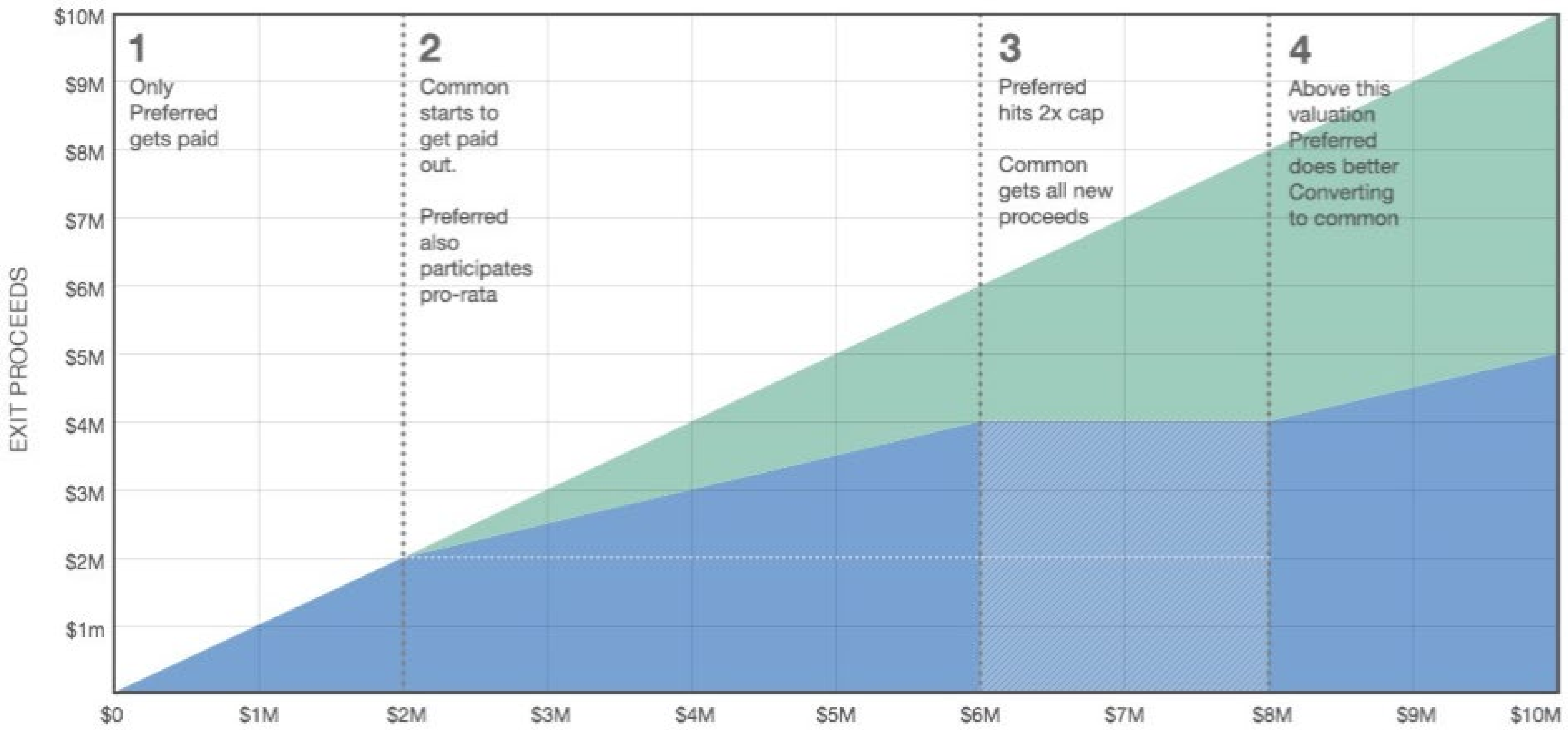


1x preference, participating with 2x cap

https://tools.ltse.com/funding-your-startup-a-founders-guide-to-liquidation-preferences-e7db39469463



How likely is participating preferred? And what are typical caps on participating preferred stock?

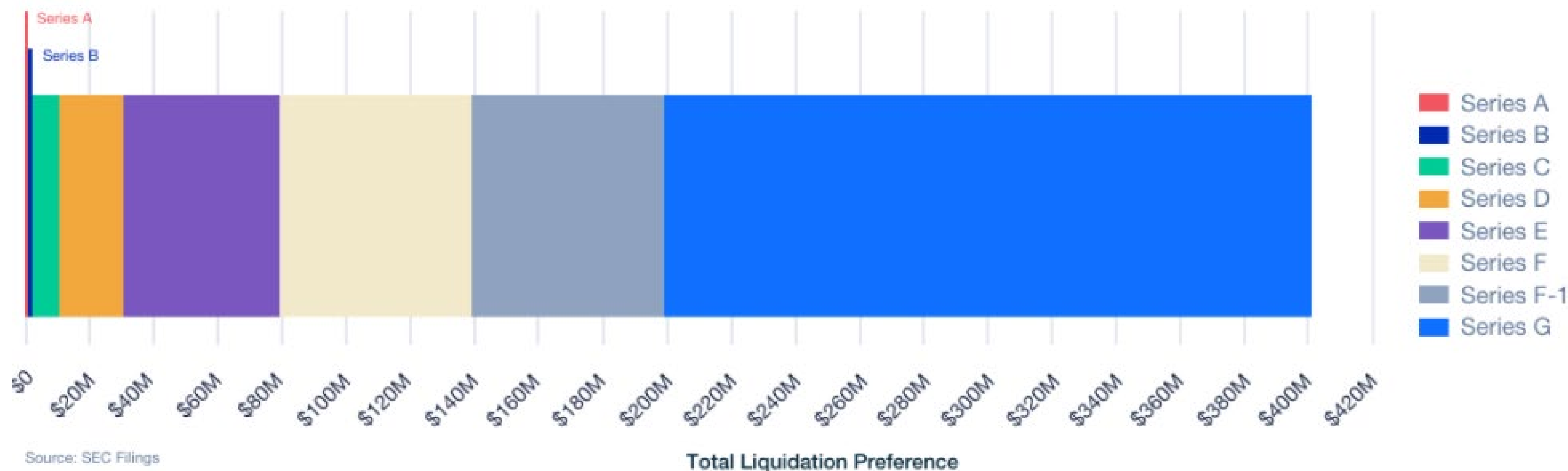
Only 50% of Series A financings have participating preferred. Of those 50%, half (25% of the total) have uncapped participation rights while the other half (25% of the total) have caps at various levels.

	Series A	Series B
No participation beyond 1x liquidation preference	50%	41%
1x -- 2x	7%	10%
2x -- 3x	13%	13%
Greater than 3x	5%	4%
Uncapped (full participation)	25%	32%

Seniority structures and liquidation preferences

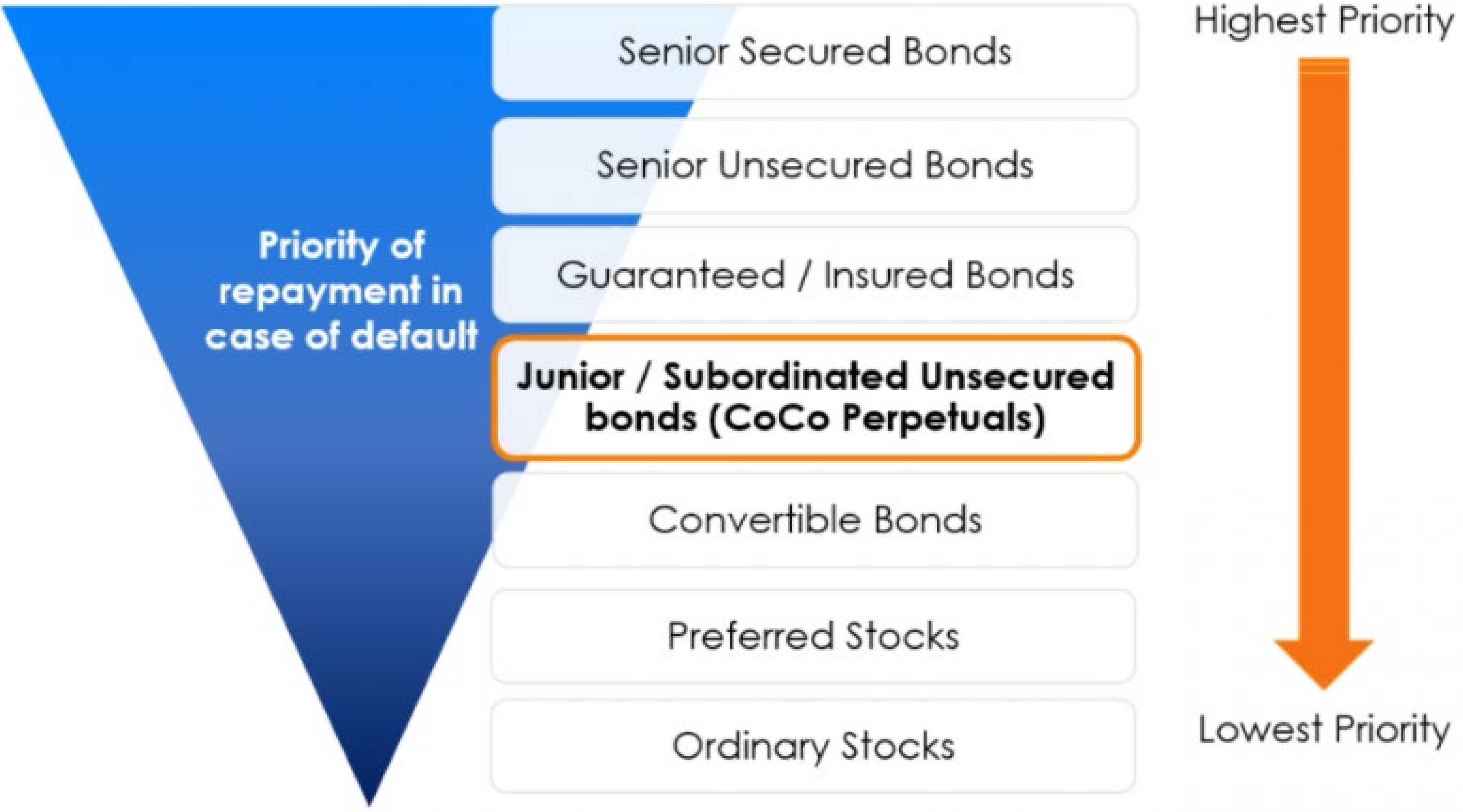
Where do you fall in the payout order when there are multiple investors?

1. Standard Seniority
2. *Pari Passu*
3. Tiered



Standard seniority

In this structure, liquidation preference payouts are done in order from latest round to earliest round. This means that in the event of a liquidation, Series B investors will be paid back their full liquidation preference before Series A investors receive anything. If both Series B and Series A investors commit $1M each with 1x liquidation preference and the company is sold for only $1M, Series B investors will receive the full exit proceeds with Series A investors getting nothing. **The majority of startups follow this seniority format**. Fundraising is tough for most companies so later stage investors are able to demand priority seniority because earlier investors depend on them to fund the company's survival.



https://bondevalue.com/news/perpetual-bonds-key-risks-to-know-before-investing/

Pari passu

- For this structure, **preferred shareholders across all stages have the same seniority status**. This means that every investor will receive a piece of the proceeds. For example, Palantir has completed financing rounds up to Series K with *pari passu* seniority. Every investor from Series A (2005) to K (2015) has equal priority when receiving exit proceeds.{What about Sompo investment in June 2020?}
- For *pari passu* payout, investors share proceeds pro rata to capital committed in the event that there is not enough proceeds to fully cover all investors. To illustrate this, Palantir has raised about $2.7 billion (Bn) in total with 1x *non-participating* liquidation preferences. Their Series F investors have committed $70M, which is 2.6% of total funds raised; while the Series J investors have committed $400M, which is 14.8% of total funds. If the company was ever liquidated for only $100M, Series F investors will receive $2.6M (2.6% of exit proceeds) in liquidation preferences and Series J investors $14.8M (14.8% of exit proceeds). It is important to note that liquidation preference payouts have nothing to do with equity ownership here.

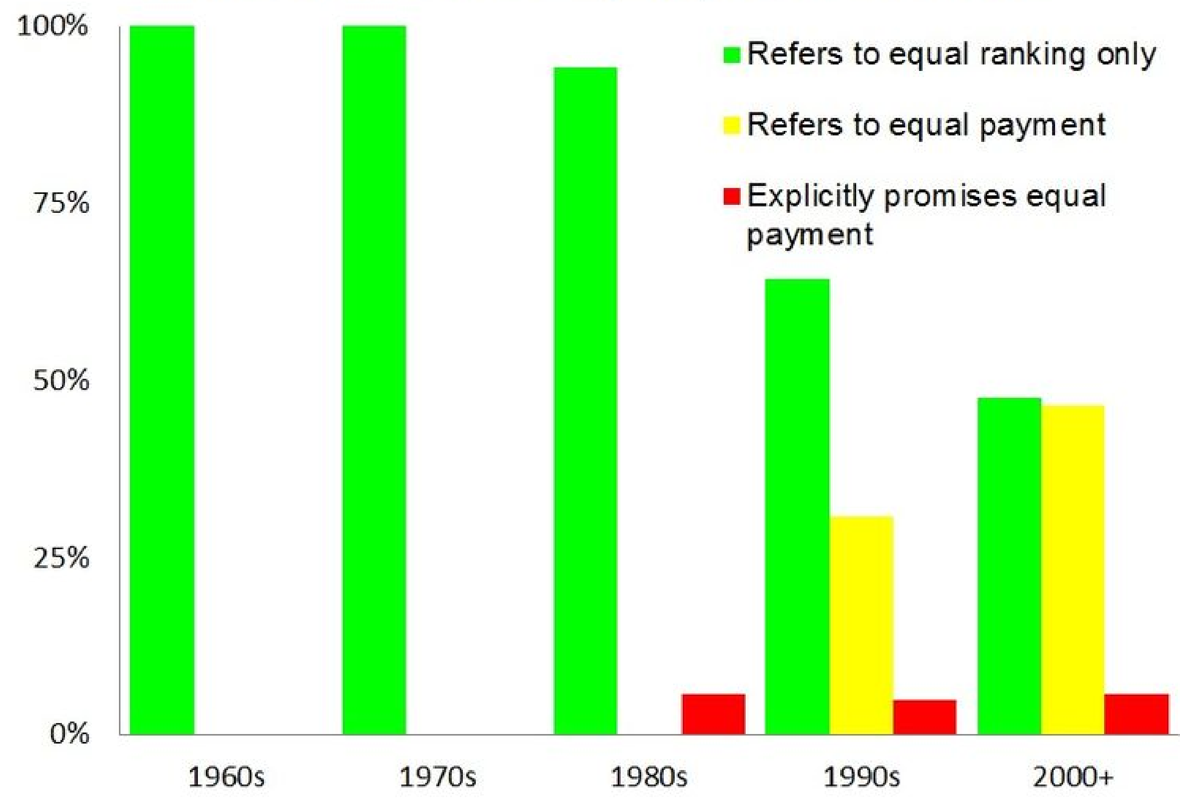
Pari passu

For investors, the *pari passu* format makes *non-participating* payouts complicated. Because *non-participation* leaves investors with two options (whether to exercise their liquidation or convert), investors' decisions are mutually dependent on each other's. Recall that choosing to convert allows one to be paid back in proportion to equity ownership by converting preferred shares into common shares. This conversion into common shares technically means that this payout will happen **only after preferred shareholders' liquidation preferences on your seniority level** are paid back. If a company is sold for $100M, an investor with 50% ownership might expect $50M in payout after conversion. However, if every other investor chooses to exercise their liquidation preferences, the converted investor will receive 50% of a significantly smaller remainder of the proceeds (<$100M). The remaining proceeds may fall below this particular investor's original conversion point. This scenario only happens under *pari passu* format due to shared seniority.

Pari passu

So while every investor technically has the same seniority, decisions will always start in order of investors with the highest conversion point (typically at the latest stage) to the lowest conversion point. This ensures that conversion decisions are optimal for all parties.

The *pari passu* structure is commonly found in unicorn companies, especially those started by prominent founders. Top startups do not have a shortage of funding so later stage investors have no leverage to demand any seniority. In addition, many prominent founders are early stage investors in their own company (i.e. Peter Thiel for Palantir) and would reject any liquidation seniority that was above them.


Different versions of pari passu over time
100%
75%
50%
25%
0%
Refers to equal ranking only
Refers to equal payment
Explicitly promises equal payment
1960s
1970s
1980s
1990s
2000+
Adapted from Mark Weidemaier, Bob Scott, and Mitu Gulati, Origin Myths Contracts, and the Hunt for Pari Passu, Law and Social Inquiry (forthcoming)

Tiered seniority

- In some cases, investors from different rounds can be grouped up into tiered seniority levels. For example, SpaceX raised about $1.2Bn across 7 rounds. Their Series G to E investors share the highest level of seniority. Their Series D investors share the middle tier. And their Series A to C investors share the lowest tier among preferred shareholders. Within each tier, investors follow the *pari passu* payout. You can think of this as a hybrid between the standard seniority and *pari passu* design.
- While this piece breaks down fundamental features of a liquidation preference and provides common seniority arrangements covered by 99% of all startups, it is important to remember that liquidation preferences can be legally structured in any way. Some companies have exotic variations of the typical setups. Thus, it is important to read legal language carefully in a term sheet (if you are a founder) or certificate of incorporation (if you are an investor) to have a clear understanding of where you stand among others on the cap table.

Founder (re)vesting

- Standard vesting = earn the "right" to exercise stock options (or keep stock already purchased) based on certain milestones
- Milestones typically are time-based, but can also be performance-based
- "Typical" employee vesting = 4 years
  - One year "cliff"
  - Monthly/quarterly for remaining 3 years
- Founders typically already own stock purchased at company founding
- Investors want incentives to ensure founders don't leave soon after financing is closed
  - Among multiple founders, they should each also want this with respect to each other
- Require founders to "re-vest" a portion or all of stock already owned
  - Company has the right to repurchase stock not vested if/when founder leaves
- Typical outcome =
  - 25-33% "credit" for time already put in
  - Re-vest remaining 67 -75%> over 2-3 years
  - Often adjusted if departure 'for cause "without cause",
  - by resignation with or without "good reason"

Vesting today

- Now vesting periods are back to what they were at the start of the 1990's.
- Median periods for linear vesting around four years, longer for founders shares.
- Optimum new vesting model is:
  - Half of the founders equity vest over 3 years
  - Half vests only on a sale of the company.
  - All vesting accelerates on a sale.
- Considered the best alignment between investors and team members.

Yes, but my shares are vested

- Still a few entrepreneurs,
- Who think their shares have already vested.
- And still want the investors to think about investing.
- Darwin will take care of them.

Board of directors

- Size = odd number typically 3 (seed) to 7 (late stage)
- If not specified, each member elected by vote of all shareholders
- Specific "seats" often designated by subset of shareholders
  - Specific class of stock
  - Min # of shares owned
  - Specific named investor
  - Specific management team member/title
- Observer seats often allocated to key investors
- Minimum meeting frequency

- Typical:
  - Each class of stock = right to elect one director
  - One director = CEO or highest ranking business officer
- Additional directors elected by variety of "custom" ways:
  - Independent
  - jointly elected by subset of other directors
  - jointly elected by subset of shareholders
  - Separate "nomination" from approval
- Key issue = how vacant seats are filled

Harder to attract good directors

Business in Vancouver February 18-24, 2003

Insurance hikes force lawyers off boards

Clark, Wilson discourages appointments; partner off DataWave board

Tracy Tjaden

U.S. corporate governance scandals have pushed insurance rates sky-high, forcing one Vancouver law firm to discourage its lawyers from sitting as directors of public companies.

Bernard Pinsky, a partner of corporate law firm **Clark, Wilson**, resigned from Vancouver-based **DataWave Systems Inc.**'s board of directors February 7.

In total, Clark, Wilson lawyers have resigned from half a dozen boards in recent months.

Two years ago, its lawyers sat on about 25 boards of public companies, Pinsky said. The firm's lawyers are in the process of resigning from all pubic company boards.

The firm's insurance costs for directors' and officers' liability insurance shot up 150 per cent this year over last year. That's after a 75-per-cent increase last year over the year before.

"It's the big corporate governance failures in the U.S. that have driven rates up because [the insurance companies] are paying out billions," said Pinsky.

DOMINIC SCHAEFER

Resigned: Lawyer Bernard Pinsky left DataWave board due to insurance costs

Misc. Notes on other terms

- **Anti-Dilution**: never agree to "full ratchet"
- **Cap Table**: pay attention to how options, warrants, and employee pool affect calculations
- **Dividends**: make sure they are not automatic or cumulative
- **Redemption rights**: almost never used
- **Registration rights**: almost never survive intact to IPO anyway
- **Legal costs**: company always reimburses investors' legal costs. Mandate fixed fee for lawyers on both sides if possible
- **Protective provisions, voting rights, investor rights**: "devil is in the details" be careful and meticulous here
- **No shop**: make sure specifics are well understood, and company can terminate at will
- **Employee agreements**: start chasing down early- signatures of departed employees often cause delayed closings

Key takeaway: ownership % ≠ payout amount

- Cap Table and Exploding Pie Illustrate Simple Ownership Percentages
- Term Sheet provisions alter the payout values and voting control rights from a simple ownership percentage-based determination
- Terms that affect economic payout values:
  - Liquidation preference
  - Dividend rights
  - Redemption rights
  - Option exercise provisions
  - Seniority vs. "pari-passu" economic treatment

"Ultimately investors care more about whether the value of the stock has changed more than whether or not there percent ownership has changed." – Stephanie Hanbury-Brown of Golden Seeds

- Terms that affect voting control rights:
  - Board selection
  - Protective provisions
  - Investor rights agreement
  - Conversion ratio of preferred stock

"When structuring the term sheet in a deal negotiation, various terms and conditions have different priority. What's always important to remember is that percent ownership does not mean percent control." – Stephanie Hanbury-Brown of Golden Seeds

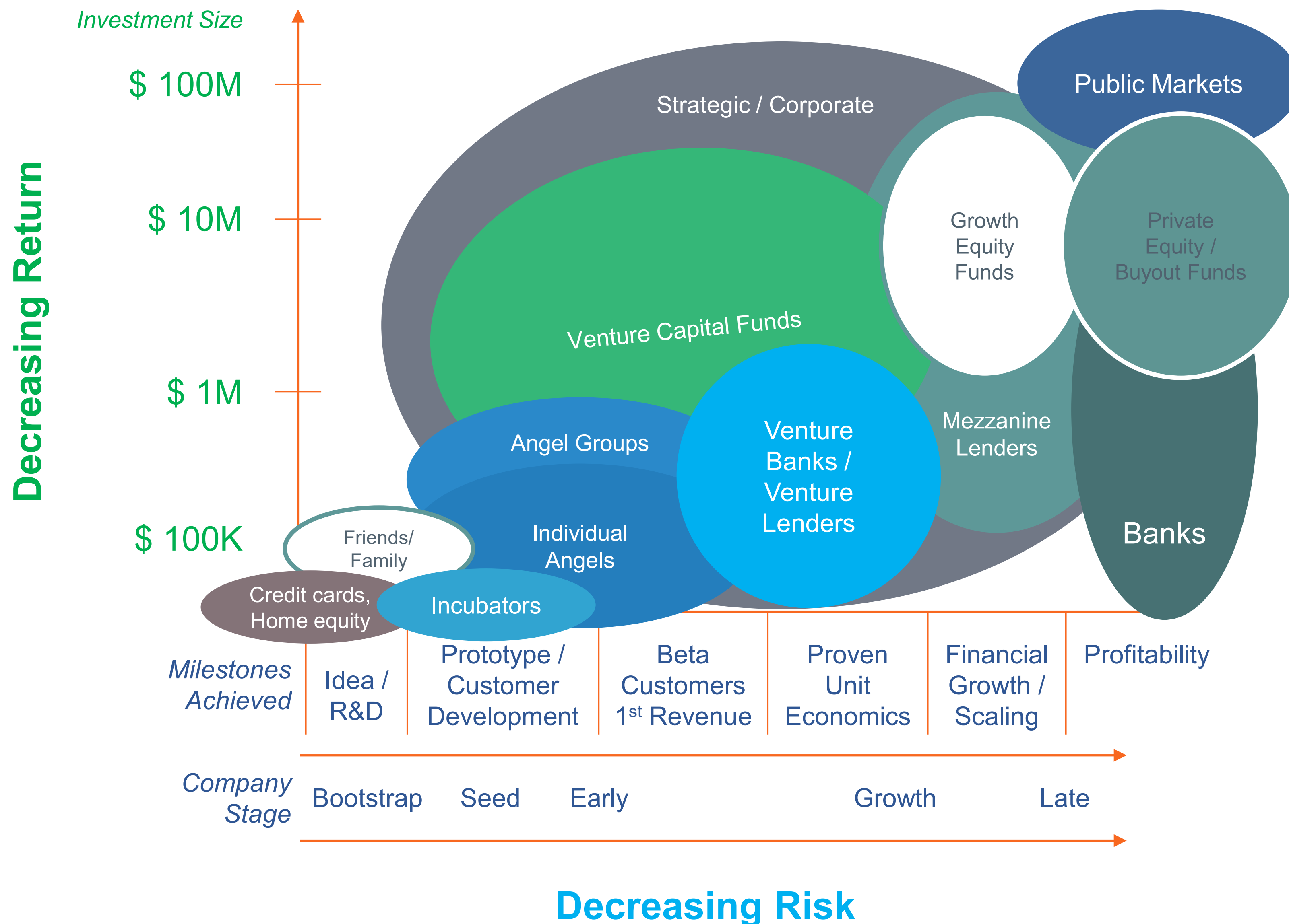
Reality
Check
FRONT
3

Takeaway lessons

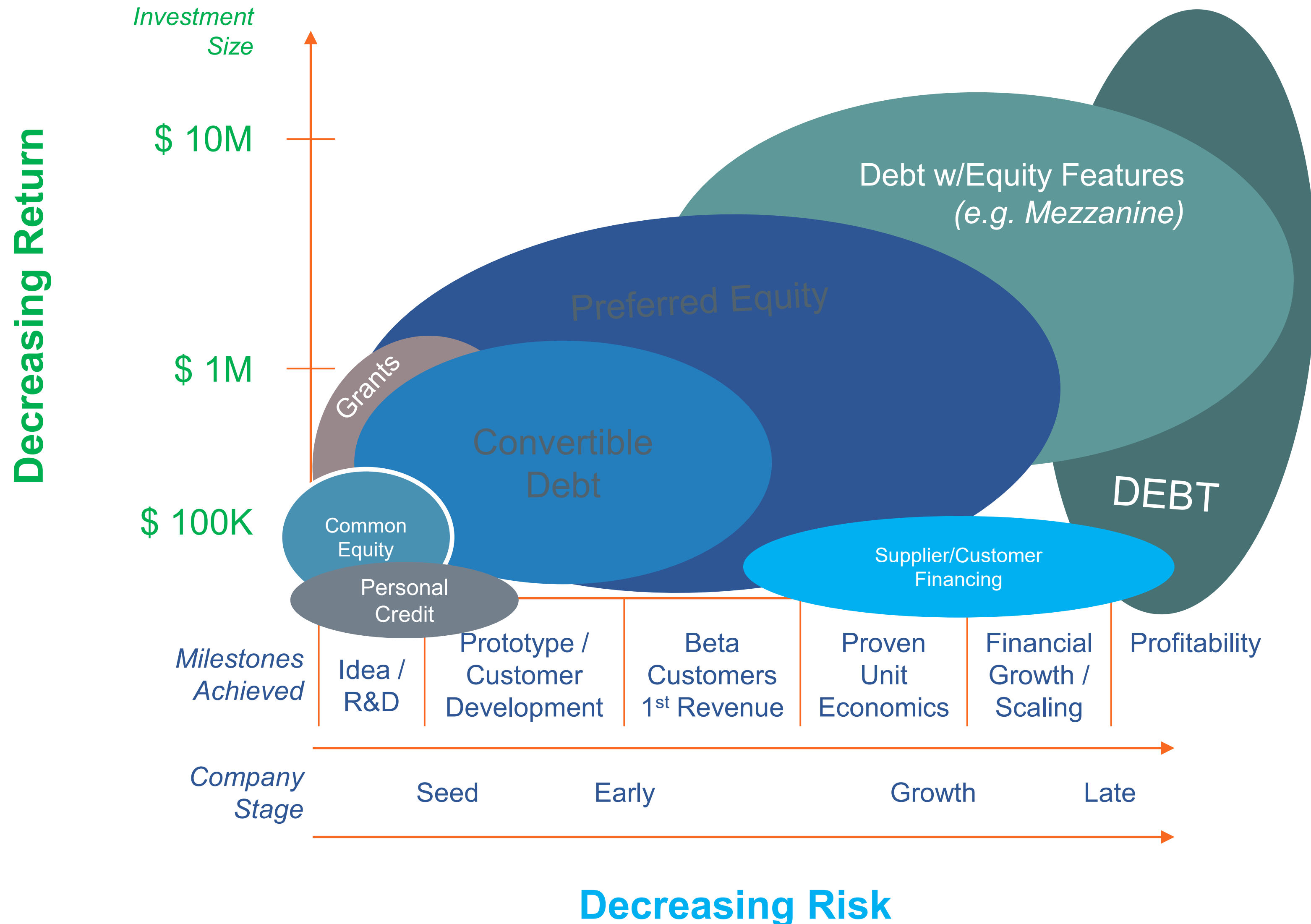
1) The key gap between entrepreneur and investor mindsets is the way they approach and assess **RISK**.
   Staged financings are a useful way to bridge this gap.
2) The size of one's **ownership percentage** of a company (and hence the valuation of a financing) are less important than:
   a. the rate of increase in the **value** of the overall company
   b. alternative provisions in **terms** of financings that change the economics and control
3) Venture capital transactions can be summarized in term sheet documents, but a VC-entrepreneur "deal" can only be assessed in the larger context of **long-term alignment**.

Backup Slides

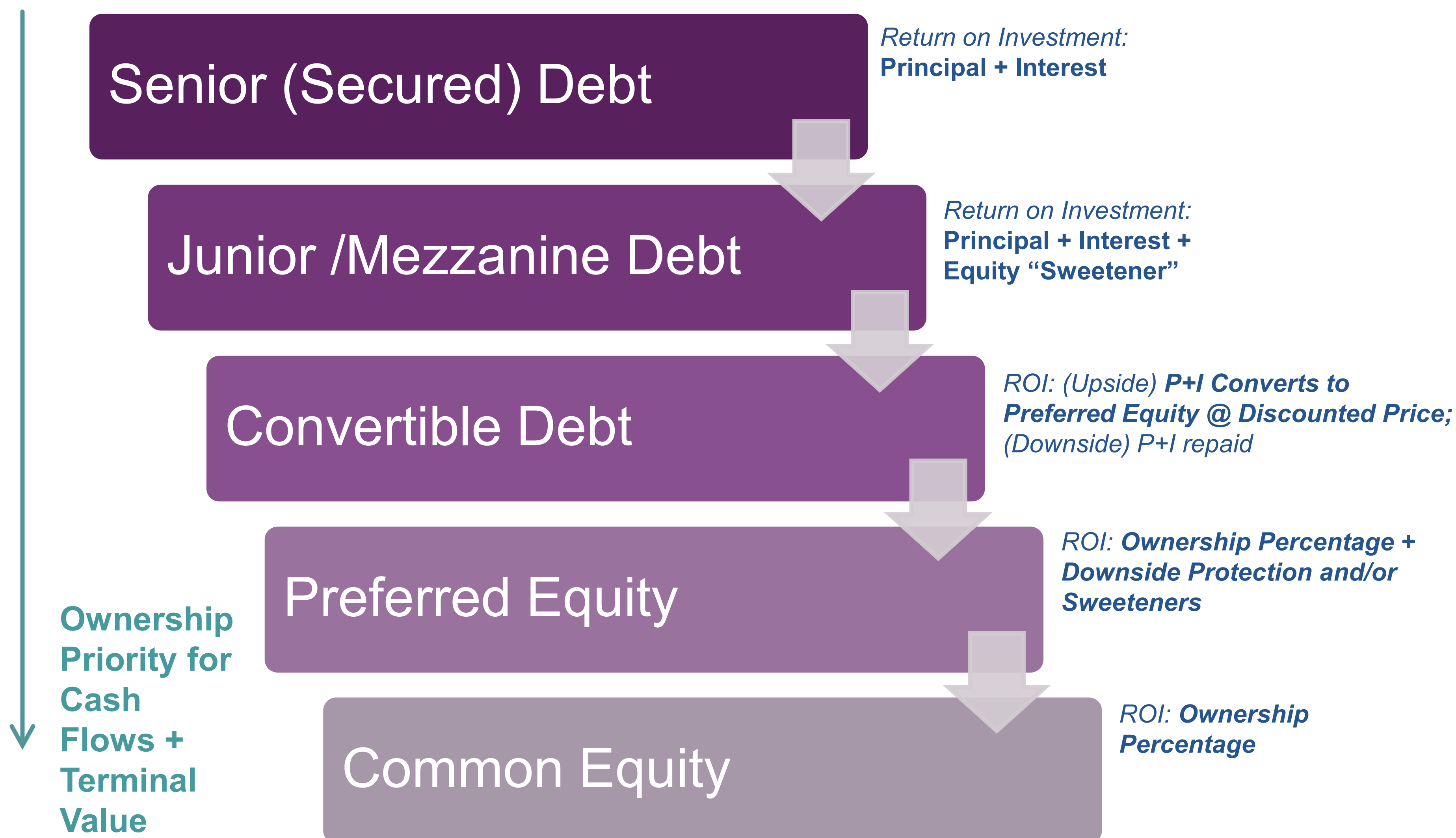
Review: sources of capital



Review: capital structures

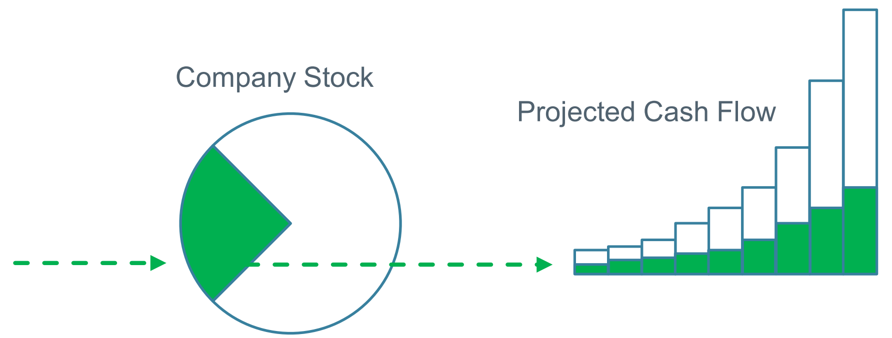


Primer on capital structure hierarchy

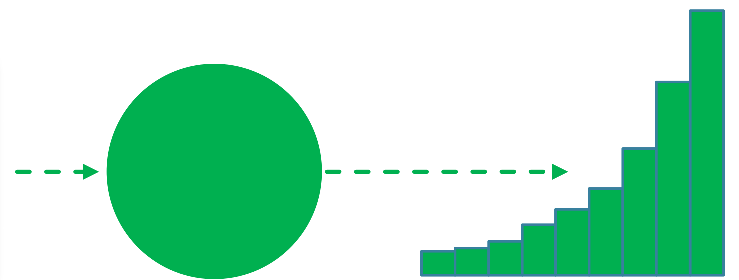


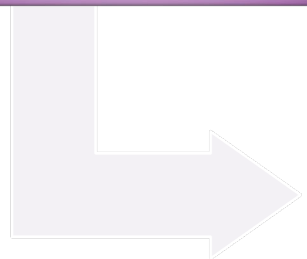
Review: the investment mindset

A share of stock gives you the right to a share of the future cash flow streams + terminal value of the company



If you bought all the shares, you would have the right to all the future cash flow and terminal value





What would that be worth??

Ref: Geoff Moore / Chasm Group LLC

Answering the key investor question

The Value of an Investment Equals:

- What an Investor Will Pay **TODAY** For the Investment

The present value of…

- Time Value of Money
- Depends on "Risk-Free" Rate

A future cash flow stream…

- Annual Projections plus
- Terminal Value at Liquidity Event
- Represents Investor Version of Story Arc

Discounted for RISK

- Drives Almost All Entrepreneurial Investments
- Represents How Much the Investor Believes in the "Story," Plot and Characters

In reality, the entrepreneur's decision is similar to an investor's

The Cost of Investment (Dilution, Control) Equals:

Need for Financial Resources to Eliminate Risks

Value of Investors' Reputation, Network, Advice

Discounted for Reduced Control

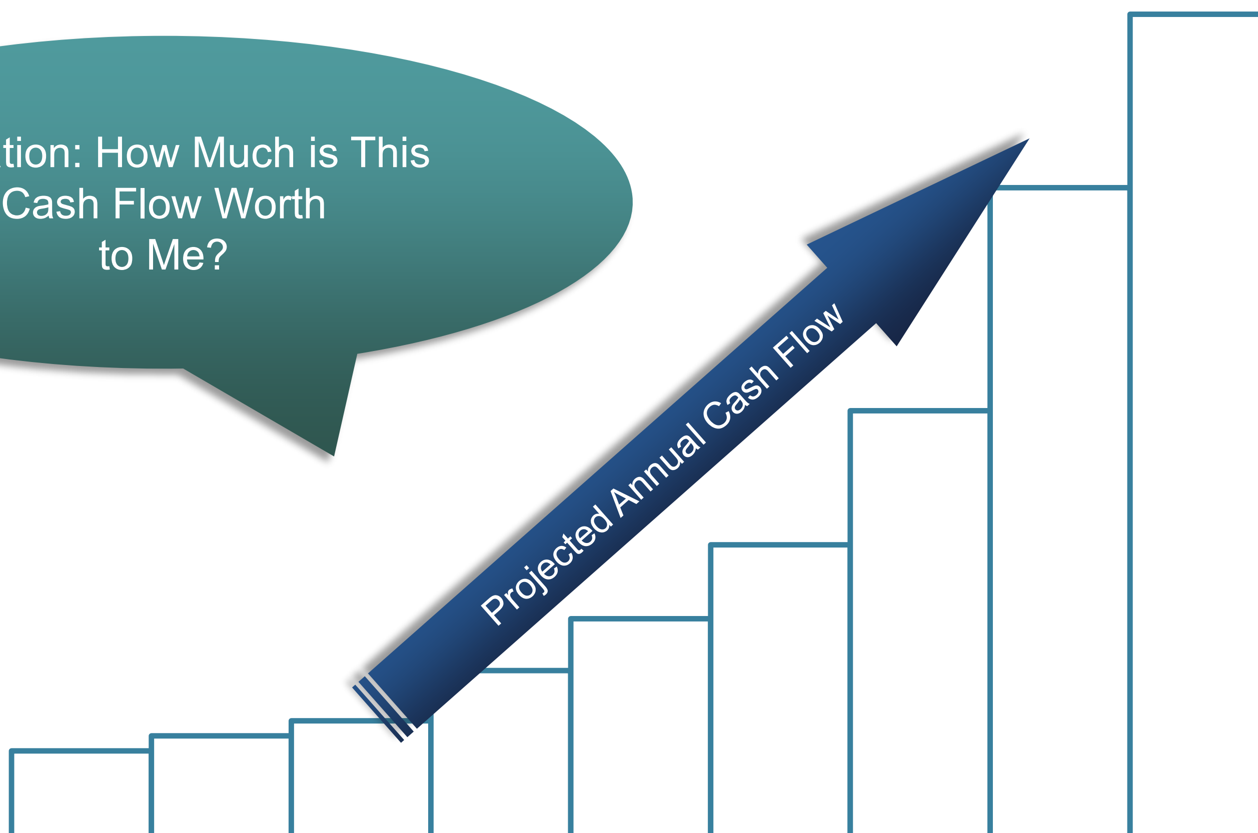
Valuation = process for evaluating what A company is worth

* Valuation only has meaning in context of the risk/reward goals of a specific investor

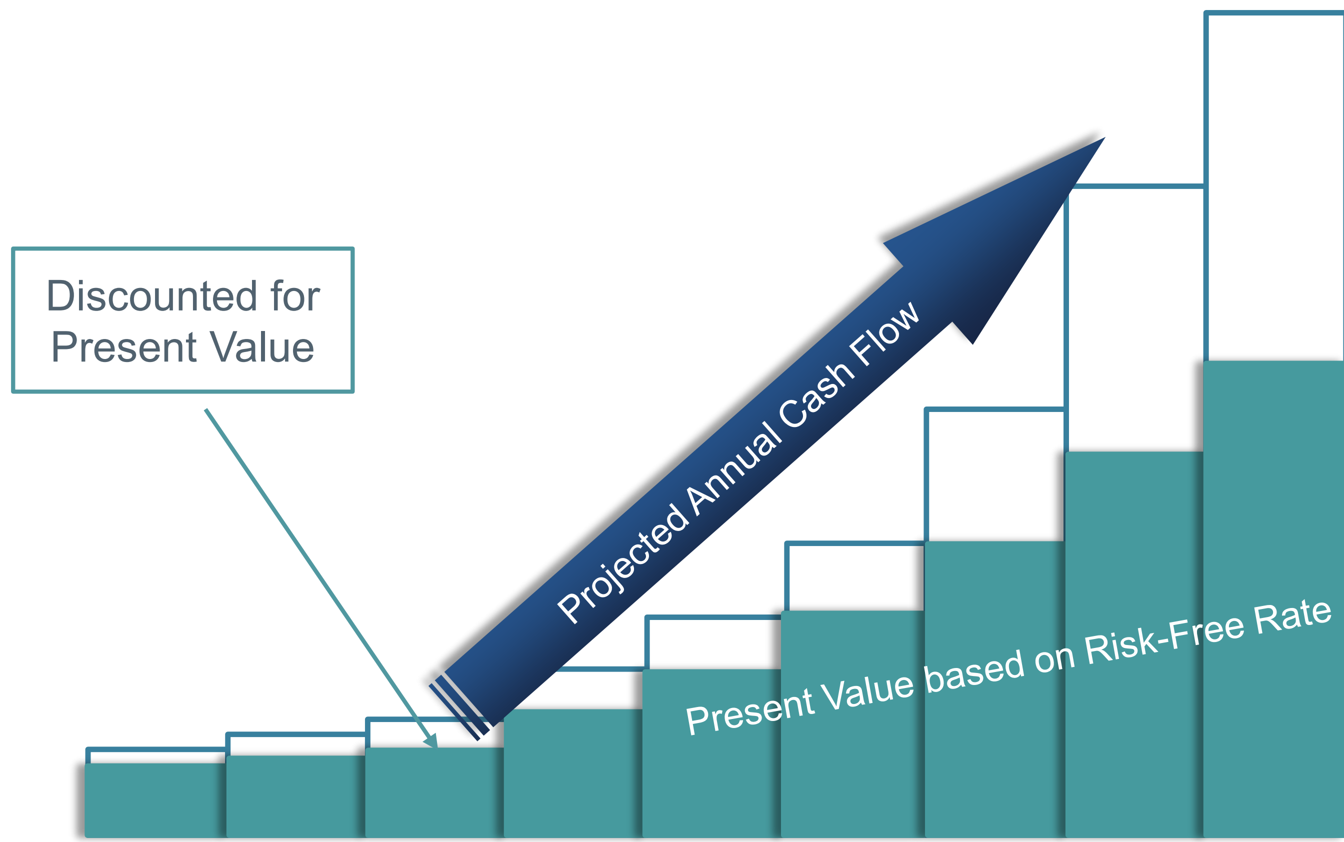
Ref: Geoff Moore / Chasm Group LLC

Things Are Ultimately Only Worth What Someone Is Willing to Pay for Them

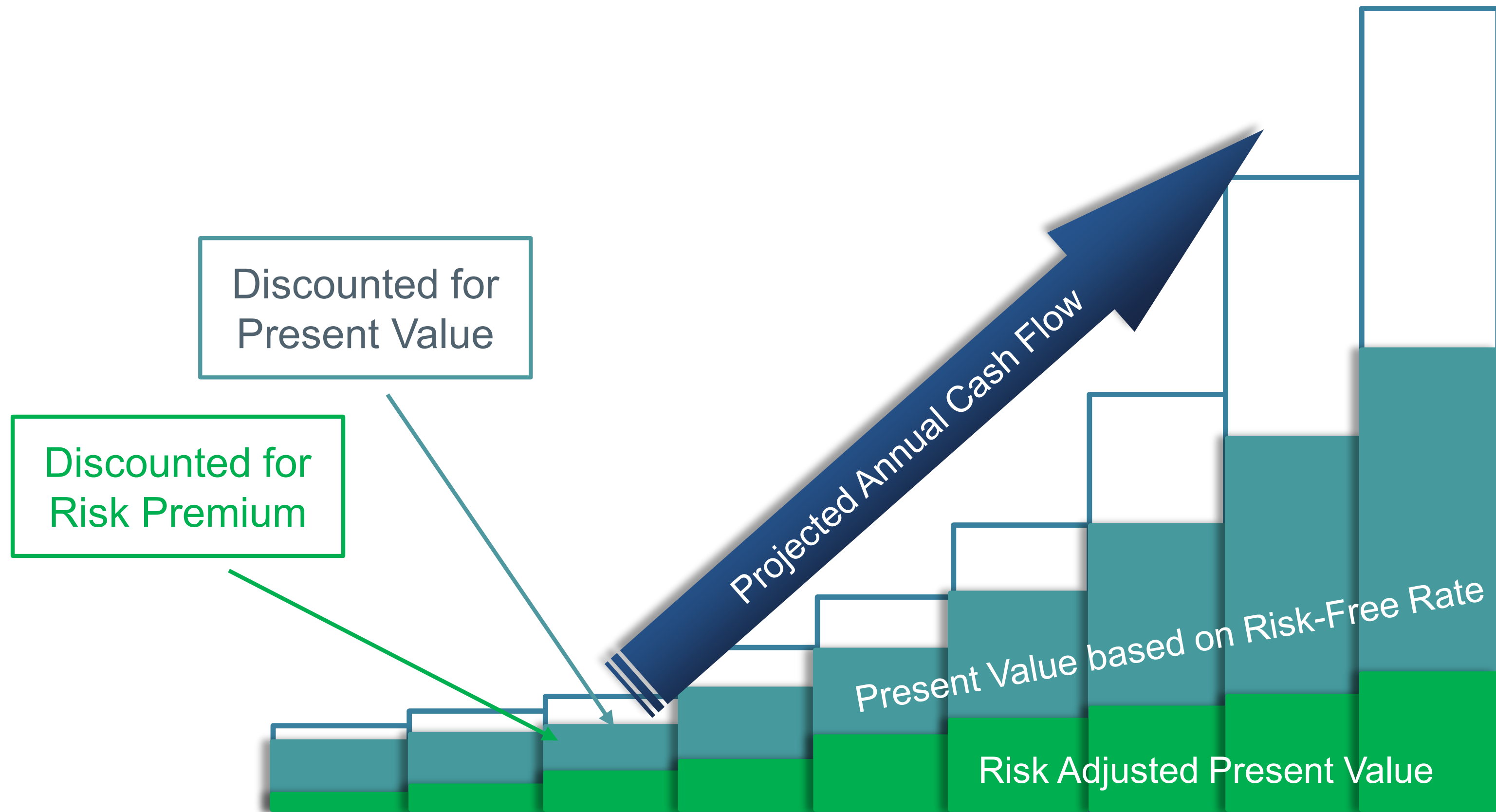
Discounted cash flow (“DCF”) = basic investor metric for measuring value of a entrepreneur’s “story”



First step: present value calculation



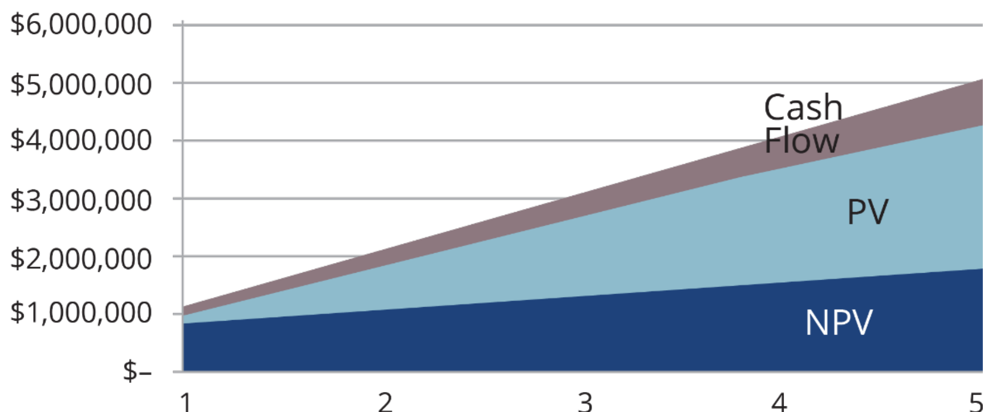
2nd step: discount for risk premium



DCF example

Assumptions: Risk-Free Interest Rate = 3%; Risk Premium Rate = 20%

Year	1	2	3	4	5	Total
Project Cash Flow	$1,000,000	$2,000,000	$3,000,000	$4,000,000	$5,000,000	$15,000,000
Discounted to Present Value (PV) = CF / $(1^RFR)^N$	$970,874	$1,885,192	$2,745,425	$3,553,948	$4,313,044	$13,468,483
Discounted to Risk-Adjusted Value (Net Present Value or NPV=PV / $(1^RPR)^N$	$809,962	$1,309,162	$1,588,788	$1,713,902	$1,733,316	$7,155,130



This is the DCF "answer" for what is this projected cash flow series is "worth" today

Bad news: DCF is useless for most early-stage entrepreneurial investments

Assumptions: Risk-Free Interest Rate = 3%; Risk Premium Rate = 20%

Year	1	2	3			Total
Project Cash Flow	$1,000,000	$2,000,000	$3,000,000			$15,000,000
Discounted to Present Value (PV) = CF / (1^RFR)^N	$970,874	$1,885,192	$2,745,425			$13,468,483
Discounted to Risk-Adjusted Value (Net Present Value or NPV=PV / (1^RPR)^N	$809,962	$1,309		3,902	$1,733,316	$7,155,130

Who knows what the right risk premium rate is?
(For VC typical failure rates, probably needs to be at least 40-50% per deal)

Who knows what the actual future cash flows of this company will be?

- Investor "rule of thumb:" divide by 2, multiply by 50% and push out by a year
- Also, DCF assumes no additional capital infusions – poor assumptions for most VC deals

Since VCs rarely get paid via dividends, **who cares what the interim cash flow value is** until the company reaches an exit with liquidity?

→ DCF =
"Measure With Micrometer,
Mark with Chalk,
Cut With Axe"

Sources

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How to Crossover to a Hybrid Fund – Part 1

How to Crossover to a Hybrid Fund – Part 2

How to Crossover to a Hybrid Fund – Part 3

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