South Carolina Angel Network

Deal terms for early stage companies

March 2016

Quick disclaimer

- We will cover (briefly) complex legal, accounting, and tax issues
- Can have much more significant implications, and potential expense, than this seminar covers
- If you are creating investment documents, hire experienced counsel or accountants
- I am not an attorney or providing legal advice!

A brief introduction

Venture Carolina: 501(c)(3) that educates investors and entrepreneurs to help improve the market for early stage capital in the Carolinas

South Carolina Angel Network (SCAN): network of angel investor groups and funds across SC

Crowdr.tv: crowdfunding platform that integrates livestreaming and immediate Q&A into fundraising efforts for anyone raising money. SCAN portfolio company based in Charleston

Our agenda for today

A. Introductory terms – who, type, how much, from whom

B. Economics

- Price
- Liquidation preference
- Liquidation participation
- Anti-Dilution
- Conversion
- Dividends
- Fees

C. Control

- Board of Directors
- Protective Provisions
- Drag Along
- Information Rights
- Redemption Rights
- First Refusal Rights
- Registration Rights
- Co-Sales

D. Employee terms: vesting, pool, inventions agreements, founders' activities

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A.1. Introductory terms

A. Introduction – who, type, how much, from whom

- Who is raising money
- Type of security being offered
- How much being raised?
- From whom?
- Disclaimer of non-binding
- Capitalization table (list of who owns what)

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A.2. Type of security

A. Introduction – who, type, how much, from whom

- Convertible preferred <u>equity</u>
  - Senior to "common" shareholders – gets paid out first
  - More protections and preferences
- Conversion
  - Converts to "common" shares at defined ratio

    Standard
    - Usually starts at 1:1 ratio, with 1 share of preferred converting into 1 share of common

      Standard
    - Either at option of shareholder

      Standard
    - Or automatically on certain events (e.g. IPO)
- Has the same other basic rights as common shareholders

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B.1. Price

B. Economics

- No-one ever agrees on valuation or even the method
- Do your homework…
- Starting point: US median funded 2014 = $3.0M; SC = $2.0M
  - For startups, art not science
  - Varies by geography and availability of capital
  - “Multiples” or “SOTP” do not work; DCF too speculative
  - But there are accepted startup valuation methodologies
- Key terms:
  - **Pre-money**: value of the business just before investment
    - Pre-investment shares * new share price
  - **Post-money**: ~ pre-money plus the investment amount
    - Post-investment shares total * new share price

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B.1. Price algebra

B. Economics

- $500,000 on a pre-money valuation of $2,500,000
  - Entrepreneur's estimate
- $500,000 in this example gets 16.67% of the company
  - Calculation:

Share of company = $500,000 / ($2,500,000+$500,000)

= $500,000/ $3,000,000

= 16.67%

- Typically angels are looking for 15-30% of the company
  - Fits general size, but does it make sense?

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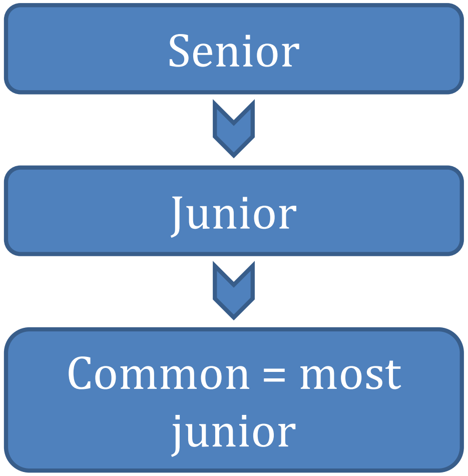
B.2. Liquidation preference

C. Economics

- Liquidation preference defines the order investors are paid at "liquidation" ("priority" or "seniority")
  - Both "good" (e.g. acquisition) and "bad" (bankruptcy)
- Priority flows:
  - Deal fees
    - Debt
      - Carve-outs (if any)
        - Liquidation preferences (equity)
          - Pro-rata across common shares



- "Preference" refers to being paid ahead of other shareholders
- Later rounds also have preferences

B.2. Liquidation preference

B. Economics

- For angels, a liquidation preference is non-negotiable
  - But the multiple varies over time
    - standard is 1x (~90% of deals that have one)
    - but some times / situations see 2-5x+ (~5-20%)
- Major impact on exit return, especially in bad exits
  - If sell company for $250,000, only investors get paid – common shareholders get $0
  - If sell for $1,000,000 and with 2x liquidation preference, only investors get paid – common get $0
  - On good exits, investors convert to common to take their pro rata share of proceeds

Standard

Investor friendly

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B.3. Anti-dilution

B. Economics

- Investors will be diluted by later rounds – which is GOOD if later capital invests at a higher valuation (larger pie)
- Anti-dilution protects existing investors in a **down round**
- No protection – bad luck (1% deals) — Founder friendly
- Weighted average dilution (96% deals) — Standard
  - Changes conversion ratio to better than 1:1, accounting for the size of the round and the valuation difference
- Full ratchet (3% deals) — Investor friendly
  - If company issues shares at lower price, our round's conversion ratio adjusted to match
- Adjusting conversion ratio not actually issuing new shares – so in practice no impact until we get an exit

C.1. Board seats

C. Control

- Board of directors control the company as representatives of (all) the shareholders
- Not necessarily the CEO or founders
- Term sheet determines how the board is structured, and sometimes who serves
  - Many variations, but typical 5 person-board

    Standard
    - 2 elected by common shareholders (founders)
    - 2 elected by Series Seed shareholders
    - 1 by "mutual consent" (of all shareholders, or of the other board members)
- What is a board for? How does it add value?
  - How to be an effective board member is a learned skill

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C.2. Investor rights

C. Control

- Information rights
  - Receive budget, quarterly and annual financials
  - Inspection and visitation rights
- Redemption rights (rarely exercised)
  - Sets possible exit horizon for investors
  - Company re-purchase shares after (5) years over (3) years
- Right of first refusal
  - 1) For existing shares, company gets first opportunity to buy any that come for sale (rare); then existing investors get second opportunity
  - 2) Existing (major) investors get first opportunity to invest in next round (usually (1) times their stake)

Standard

Standard

Standard

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