

FundingPost Venture Workshop: 8/13/03

Nisha Atre – Mellon Ventures

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Discussion Topics

- **Navigating Term Sheets**
- **Realistically Sizing Your Market**

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Pre-Money Valuation of the Company

The value of the Company prior to the venture financing should be stated on the term sheet.

- Valuation based upon financial projections and multiples (Revenue, EBITDA and Earnings) of comparable publicly-held companies
- Used to determine the per share price or “Original Issue Price”
- Option pool is usually ‘reset’ before new money is invested

Participating Preferred and Liquidation Preference

Many venture investments are structured as participating preferred stock.

- Investors receive preference to common stock and then participate in distribution as-if-converted
- In the event of a sale or liquidation of the Company, preferred shareholders are entitled to receive an amount per share equal to a multiple of the issuance price plus all dividends
 - Recent deals have been capped at 3x the preferred investment

Participating Preferred and Liquidation Preference (Cont'd)

The following example shows the impact of a participating preferred investment structure on investors.

- Assume a \$20MM preferred investment, with 3x liquidation preference and no dividends, in a company with a \$30MM pre-money valuation
 - The preferred investor has 40% ownership in the Company

	Exit Valuation (\$MM)				
	\$105	\$120	\$135	\$150	\$165
1. Conversion Calculation					
Value of Investment (40%)	\$42	\$48	\$54	\$60	\$66
2. Participation Calculation					
Minimum of A or B					
A. Participation Ceiling	\$60	\$60	\$60	\$60	\$60
or					
Preferred Investment	20	20	20	20	–
Plus: Equity Share after Pfd. and Divs.	34	40	46	52	66
B. Calculated Participation	\$54	\$60	\$66	\$72	\$66
Participation Value (Min of A or B)	\$54	\$60	\$60	\$60	\$60
Total Investment Value (Greater of 1 or 2)	\$54	\$60	\$60	\$60	\$66

The participating preferred protects a range of valuation compared to straight conversion.

Optional Redemption

This section of the term sheet provides for the mandatory repurchase of investors' shares.

- **Factors that influence whether investors can optionally redeem their shares include**
 - Minimum percentage of shareholders necessary to request redemption
 - Number of years after closing when optional redemption is permitted (usually 5th anniversary)
- **The redemption price equals either the original issue price per share plus all unpaid dividends, a fair market value or a specified ROI on the original purchase price**
- **Redemption payments can be distributed in a lump sum or at intervals (e.g., over 3 years)**
- **In reality, redemption payments are often negotiated when investors seek to redeem their shares**

Optional and Automatic Conversion

The optional and automatic conversion of preferred shares into common shares is specified in the term sheet.

- **Optional conversion**

- The preferred may be converted into shares of common stock at the option of the holder
- The number of common shares into which the preferred shares are converted is determined by dividing the original issue price by the conversion price
- Conversion is typically subject to anti-dilution adjustments

- **Mandatory conversion**

- Preferred shares are mandatorily converted upon an IPO
 - Typically, an IPO must price at three times the original issuance price to trigger mandatory conversion
 - Minimum cash proceeds from an IPO are also established to trigger mandatory conversion

Anti-Dilution Protection

Provisions are established to protect the investor from dilution of its stock during subsequent financings.

- **Adjustment of the conversion price in the event the Company issues future equity at a price lower than the original issue price**
 - Results in additional shares received at time of conversion
- **Protection mechanisms: weighted-average vs. full ratchet**
 - Weighted-average protection lowers the conversion price by weighting the offer prices by the size of the existing and new investments
 - Full ratchet adjusts the conversion price for all existing shares to the new, lower price of the subsequent financing
 - More downside protection than weighted-average
 - Weighted-average is still the most common practice, but full ratchet is becoming more common

Anti-Dilution Protection (cont'd)

The following example illustrates the differences between weighted-average and full ratchet protection.

PRE-TRANSACTION

- 50MM FD shares outstanding
- Last round at \$8.00 per share

TRANSACTION

- \$40 MM Series E investment
- \$3.00 per share
- 13.3 MM new shares

- Using weighted-average protection, the new conversion price is calculated using the following formula

$$\frac{(\# \text{ of shares before raise} + \# \text{ of shares new } \$ \text{ would purchase at the higher price per share})}{(\# \text{ of shares before raise} + \# \text{ of new shares at down-round price per share})}$$

- Series E investors would have received only 5 MM new shares if the round were priced at \$8.00 per share

$$\frac{(50 \text{ MM existing shares} + 5 \text{ MM theoretical new shares}) * \$8.00 \text{ per share}}{(50 \text{ MM existing shares} + 13.3 \text{ MM real new shares})} = \$6.95 \text{ per share}$$

- Using full ratchet protection, the new conversion price is \$3.00 per share

Protective Provisions

Several provisions mandate investor approval for material transactions.

- **Standard actions that require shareholder approval include**
 - Modification of the preferred security terms in a manner that adversely affects preferred shareholders
 - Creation of any series or class of security senior to the preferred securities
 - Merger or change in control
 - Increase or decrease in total number of shares of the same class of preferred security
 - Common stock repurchases
 - Payment of common stock dividends
 - Any “related party” transaction
- **Investors may also require approval of additional provisions, such as material changes in business**

Registration Rights

The term sheet specifies the rights of the investors with regard to registering for public offerings in order to provide liquidity.

- **Demand rights**
 - Investors can request that the Company file a registration statement (form S-1) beyond a minimum offering price
- **Registrations on form S-3**
 - A majority investor may require the Company to file up to a pre-specified amount of registration statements annually
- **Piggy-back registrations**
 - Investors are entitled to “piggyback” registration rights on registrations of the Company
- **Registration expenses from demand rights, S-3 filings and piggy-back registrations paid the Company**
- **Transfer of registration rights to an acquirer of at least 25% of an investor’s common stock**

Drag-along Rights

Drag-along rights allow major investors to “drag-along” the founders and other shareholders into a proposed sale of the Company.

- **Frequently, Board approval is required to approve the transaction**
- **A fairness opinion from a nationally recognized investment bank is also often required**

Stock Purchase Agreement

The term sheet should reference the **Stock Purchase Agreement (“SPA”)**, the legal document governing the investment.

- **In addition to containing those terms listed in the term sheet, the SPA supplements the term sheet by providing**
 - Representations and warranties of the Company and investment representations of the Investor Group
 - Affirmative and negative covenants
 - Conditions to closing
- **The term sheet often references other ancillary agreements, including a Registration Rights Agreement, Stockholders’ Agreement and a Certificate of Designation of Rights, Preferences and Privileges**

Additional Terms

In addition to the terms previously discussed, the following items are also included in a term sheet.

- **Capitalization table, showing the percentage of outstanding capital stock represented by the preferred offering**
- **Dividends offered**
- **Voting rights**
- **Operative rights (access to financial and operational information)**
- **Board representation / observer rights**
- **Rights of first offer**
- **Key-man life insurance**
- **Employee vesting schedules**
- **Rights of repurchase**
- **Transaction expenses**

Size Your Market Realistically

Don't depend on analyst numbers – they are usually overblown – CAGRs are too high – investors view them as unrealistic

- How many companies/consumers could potentially buy your product?
– Sources of data are US Dept. of Labor, US Census Bureau, etc.
- How much do you charge for your product?
- Price x # of potential customers = market size

Example of Bottom Up Market Analysis

Average Annual Revenue per Bill (\$1/bill charged/month)	\$12
Total Utility Bills in US	130 Million
If every bill is managed on an outsourced basis, total annual recurring revenue for outsourcers is (\$12 x 130 MM)	\$1.56 Billion
If we assume 50% of utility bills are outsourced, like the telecom & cable industries, total annual recurring revenue for outsourcers is (\$1.56 Billion x 50%)	\$780 Million

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Nisha Atre – Mellon Ventures

Nisha Atre, Associate, Mellon Ventures

Nisha Atre, an Associate, joined Mellon Ventures in June 2001. Nisha focuses on investments in enterprise software, applications and business services companies. Prior to joining Mellon Ventures, Nisha was a Summer Associate for EuclidSR Partners, a venture capital firm focused on early stage investments. Prior to EuclidSR, Nisha worked in product management at Sagent Technology, Inc., a business intelligence software firm. Nisha also served as a consultant in Booz-Allen & Hamilton's Information Technology Group. She is involved with investments in GiftCertificates.com, Media Ocean, and Orcom Solutions.

Nisha received her BA from Harvard College and her MBA from Columbia Business School.

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Ed Reilly – Morgan Lewis

Ed Reilly, Partner, Morgan Lewis

Edward A. Reilly, Jr. is a partner in the Business Transactions Practice. His practice focuses on the representation of private equity funds, including funds engaged in leveraged buyouts and venture capital investment, as well as emerging companies in aspects of legal planning related to financing, partnering and growth strategies.

Mr. Reilly has particular experience in representing companies and investors who are active in adopting innovative strategies in the financial services, energy and other regulated industries. Representative clients include Canaan Partners, Conning Capital Partners, Triumph Capital Group, Shawmut Capital, Saugatuck Capital, RFE Investment Partners and Dominion Ventures.

Mr. Reilly has represented the private equity investors in Telebanc, now E*Trade Bank. He also represented the providers of private equity financing for mortgage.com, inc., including Canaan Partners, Dominion Ventures, Technology Crossover Ventures, Intuit, Inc. and Telebanc, and continues to represent mortgage.com, inc.'s spin-off, Open Close Technologies, Inc. Mr. Reilly's clients include the equity buyout investors that funded Suiza Foods, Inc. and Chartwell Reinsurance Company. Mr. Reilly is active in various private equity organizations.

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