

# **Financing: Stops Along the Investment Food Chain**

## **Venture Capital 101**

# Venture Capital 101

## Agenda

1. **Venture Capital Overview**
2. **What VCs Are Looking For**
3. **Preparing for VC Investment**
4. **Investor Term Sheets**
5. **Alternatives to VC Financing**

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## 1. Overview of Venture Capital

- I. Pooled Investment Vehicle - Partnership
- II. Foundations, Universities, Corps, High Net Worth Individuals
- III. Asset Allocation: 20-30% ROI
- IV. 10-Year Term; 6-7 Year Investment Period

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## 1. Overview of Venture Capital (continued)

V. 2/20 Economics

VI. 3-5 Year Investment

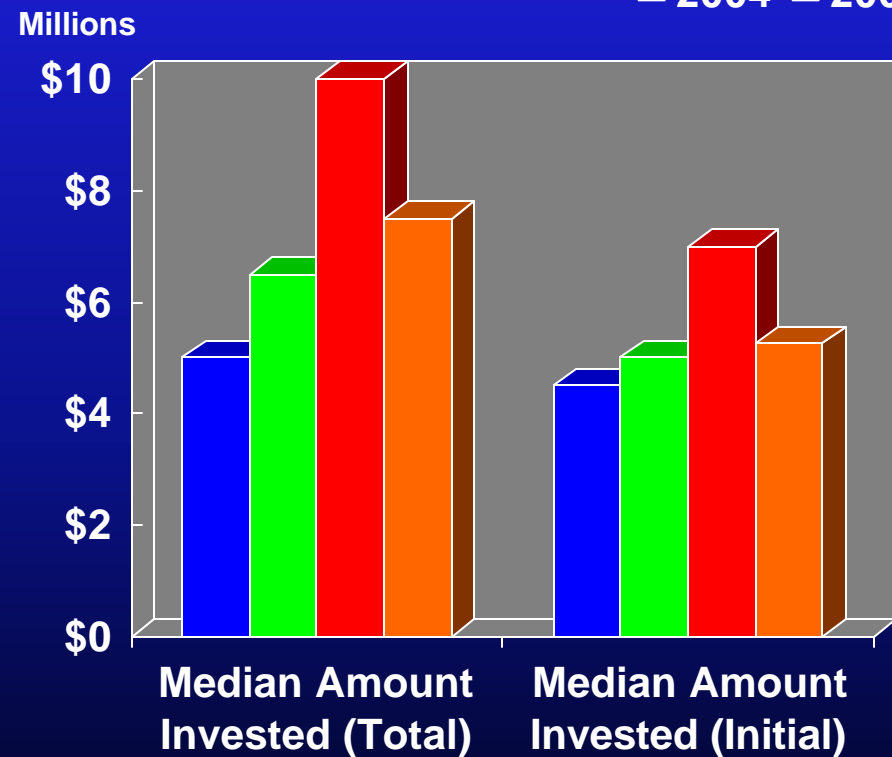
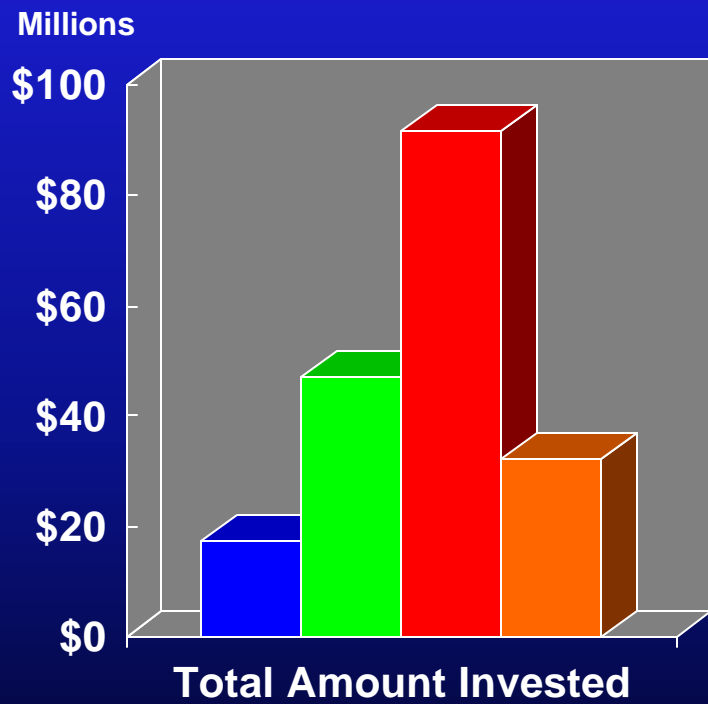
VII. Exit: IPO, Trade Sale, Recap

VIII. 6-10 Portfolio Companies per  
Investment Manager

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## Amounts Invested -- Highlights and Lowlights

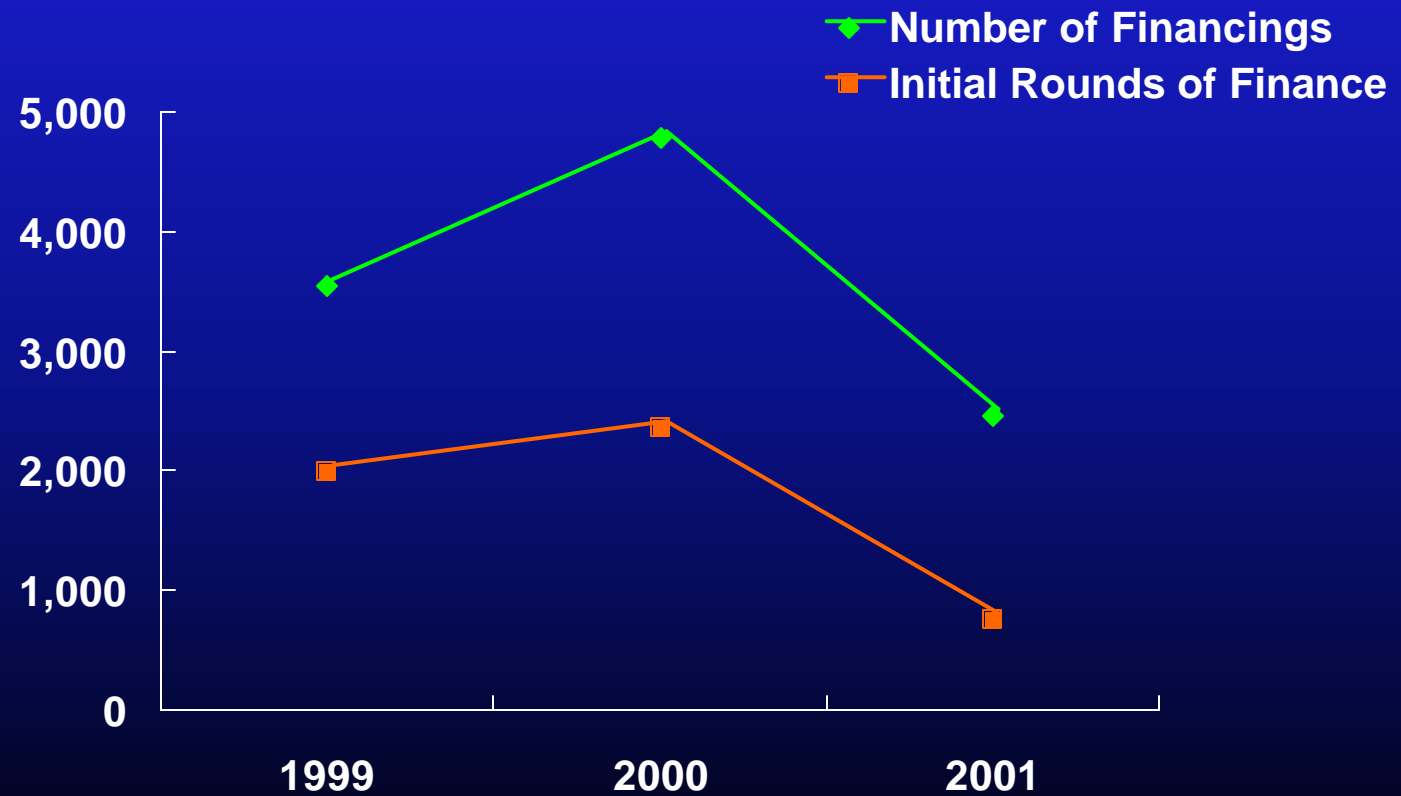
2002 2003  
2004 2005



Source: Venture One

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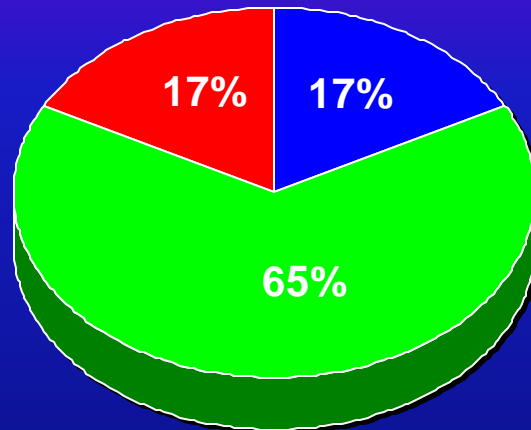
## Financings -- Highlights and Lowlights



Source: Venture One

# Venture Capital Investment Highlights - and Lowlights

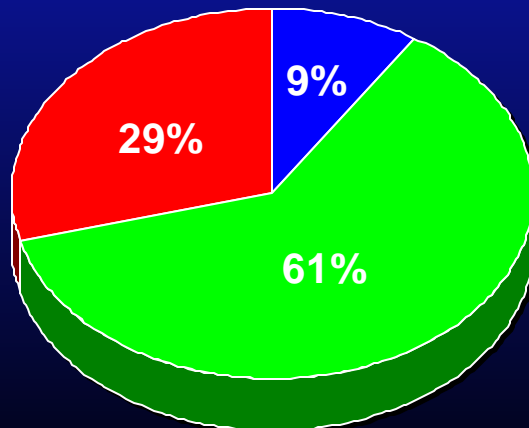
2002



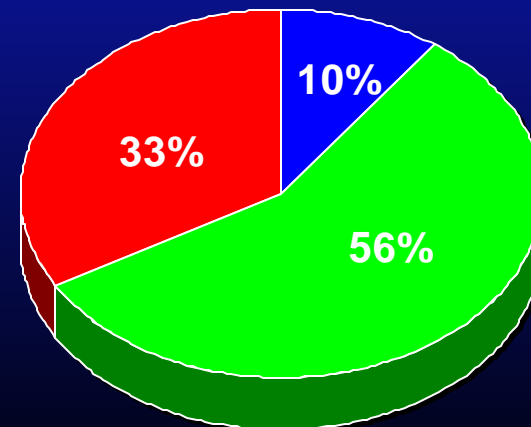
## Percentage of Financing Rounds by Industry

- Healthcare
- Products and Services
- Information Technology

2003



2004



Source: Venture One

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## 2. What VCs Look For

- I. Unique/Breakthrough Idea
- II. Barrier to Entry -- IP, Franchise
- III. No Legacy
- IV. Relevant Expertise in House
- V. Solid Management Team
- VI. 4-5x Investment in 3-5 Years
- VII. \$100 Million Business

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## 3. Preparing for VC Investment

### I. Structure to contemplate future dilution

- Cash investors
- Employees/advisors
- Founders and management typically end up with 10-12% of company on fully-diluted basis by the time of IPO or sale to another company

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## 3. Preparing for VC Investment

### Typical Structure Post-Series A

**Founders (+ Angels) = 40%**

**VCs = 40%**

**Reserve for Employees = 20%**

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## 3. Preparing for V.C. Investment

II. Organize as “C” Corporation

III. Take Steps to Protect Intellectual Property

- Copyright, Trademark

- Domain Names

- Provisional Patent or Patent

- NDA

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## 3. Preparing for V.C. Investment

### IV. Core Management Team

- Stock Vesting

- Stockholders Agreement

### V. Business Plan Executive Summary

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## 4. Investor Term Sheets

### Typical Objectives in Investment

#### I. Upside Return on Investment

- Convertibility
- Participation
- Convertible Redeemable Preferred
- Warrants

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## 4. **Investor Term Sheets** (continued)

### II. **Downside Investment Protection**

- **Liquidation preference**
- **Fixed dividend**
- **Anti-dilution ratchet**

### III. **Operational Governance**

- **Board of Directors composition**
- **Selection of key management team**
- **Consent to major actions**

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## 4. **Investor Term Sheets** (continued)

### IV. **Other Control Features**

- **Right of First Refusal**
- **Reports**
- **Affirmative/negative covenants**
  - \* **Affiliate transactions**
  - \* **Presentation to LPs**
  - \* **Confidentiality**
- **Key-man insurance**

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## 4. **Investor Term Sheets** (continued)

### V. **Exit From Investment**

- **Registration rights**
- **Co-Sale rights**
- **Drag-along rights**
- **Redemption right**

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## Sample Venture Capital Term Sheet

- **Security:** Convertible Preferred Stock
- **Pre-Money Valuation:** (including the Option Pool).
- **Capitalization:** immediately after the proposed financing :

– Common Stock	45%
– Series A Preferred	34%
– Stock Option Pool	<u>21%</u>
– Total	100%

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## Rights and Preferences:

- **Dividends:** Cumulative dividends payable upon liquidation or dissolution, redemption, (conversion)
- **Liquidation preference:** 1 1/4x original price, plus all unpaid dividends; participation with Common Stock on “as-converted” basis thereafter. Merger, sale of substantially all assets of Company treated as liquidation.

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- **Conversion:** Elective; Automatic upon vote or QPO
- **Anti-dilution:** Full/or Weighted Average ratchet adjustments for subsequent issuances of stock at a lower price, customary exclusions.
- **Consent Rights:** 2/3 vote required for: liquidation, merger, sale of all assets, increase/decrease in authorized Preferred Stock, change in the terms of the Preferred Stock, amendments to Charter or By-Laws.

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- **Optional Redemption:** 1/3 of Preferred Stock redeemable on 6th, 7th, and 8th anniversaries of Closing. Price per share = original purchase price plus all unpaid dividends.
- **Registration Rights:**
  - 2 S-1 demand registrations on S-1;
  - Unlimited S-3 demand and piggybacks.
  - No grants of additional registration rights without consent of Preferred Stock.

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- Rights of First Refusal, Co-Sale, Drag-Along:
  - Company option to acquire shares to be sold by Founders before QPO.
  - Preferred Stock may sell proportional share as part of sale by Founder.
  - Preferred Investors can purchase their pro rata share in any subsequent offering before QPO.
  - Preferred Stock right to cause Founders to vote for sale of Company if (i) no QPO by 6th anniversary; or (iii) 2/3 Preferred vote in favor.

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- **Information Rights:**
  - **Audited financials** w/in 120 days of FY end; performed by a “Big Four” accounting firm;
  - **Unaudited quarterly and monthly financials** w/in 30 days of period end;
  - **Progress reports** from the CEO (research, development, sales, marketing, etc.) monthly;
  - **Annual budget** 30 days before each FY.

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- **Information Rights:** (continued)
  - **Non-Competition Agreements:** Founders and Key Employees not to compete with Company for one year after termination of employment.
  - **Attorneys Fees:** Fees not to exceed a certain dollar amount and expenses of such counsel will be borne by Company.

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## 5. Alternatives to VC Financing

I. Friends & Family

II. Angels

III. Corporate/Strategic

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