

VENTURE FINANCING TERMS

A term sheet outlines the broad parameters of a venture financing. Well drafted term sheets are expressly non-binding (with a few exceptions including confidentiality and exclusive negotiation provisions) and are conditioned on various matters including (i) the venture firm's satisfaction with its due diligence review of the company, and (ii) execution of a satisfactory stock purchase agreement and related documents. A key component of any term sheet is the valuation applied to the company. However, the ultimate return on investment may be affected more by other terms than the company's valuation in the term sheet.

Generally speaking, valuation methods of a private company may be characterized as asset-based,¹ income-based² or market-based.³ Each method entails various limitations and assumptions that make valuation a combination of art and science.

Angel Valuation. It may be impossible to determine a satisfactory pre-money valuation in an "angel" round.⁴ For this reason, the company and angel investors may postpone the valuation/pricing decision to the Series A round of financing when pricing by professional VCs occurs. In this scenario, a bridge loan or convertible note may be used. The bridge loan or convertible note would carry a future right to convert the loan principal into common or preferred stock based on a discount of 20% or more to the price of equity in the Series A round.

VC Valuation. Assume that the company is successful enough to attract a \$5 million Series A investment by professional venture capital investors.⁵ Using an income-based method of valuation, further assume:

D = discount rate of 40% used by investors

I = investment amount of \$5 million

T = time to exit of 3 years

V = terminal value at time of exit of \$30 million (no interim cash distributions)

¹ Examples include book value, adjusted book value and liquidation value. Asset-based valuations ignore future value expectations.

² Such as net present value and internal rate of return. In general, income valuation methods are a function of capitalization rates or discounted cash flows using projected income streams with a terminal value discounted to present value. In addition to the projection assumptions, the discount rate (which reflects the estimated risk/required investor return) significantly affects the value.

³ Comparison to market values of publicly traded companies (satisfactory comparables are frequently difficult to find).

⁴ Seed round financing by high net worth individuals.

⁵ For efficient investment of the VC investor's fund, many VC's will not consider small investments (e.g., \$3 million or less).

The net present value⁶ of the company on a post-money basis is \$10, 933,000.

The pre-money valuation of the company is \$5,933,000.⁷

The investor must acquire 54.27%⁸ of the company to achieve its required rate of return.

If the company has 500,000 shares outstanding to its current shareholders, the investor will be issued 593,374 shares⁹ at \$8.43 per share.¹⁰

Regardless of the valuation method, consider the following factors:

1. The investment valuation does not determine the ultimate profitability of the investment on the sale or IPO of the company.¹¹
2. The investment valuation determines primarily the investor's initial ownership percentage of the company.
3. The post-money valuation assumes that the investor is receiving only common shares – an unlikely event.

Impact of Terms. VC investors typically receive convertible preferred shares. Each preferred share may receive a multiple of its original share price (“liquidation value”) upon sale, IPO or other liquidation of the company and may thereafter “participate” in any additional proceeds distributable to the common shareholders. For example, assume that 500,000 shares of common stock issued at \$0.01 per share are outstanding prior to the Series A round and the Series A convertible preferred stock:

1. is convertible on a 1:1 basis into common stock;
2. is entitled to two times its original price per share upon a “liquidation event”;¹² and
3. participates on an “as converted”¹³ basis in the remaining liquidation proceeds.

⁶ $NPV = V/(1+D)^T$

⁷ Post-money valuation minus the amount invested (I).

⁸ Amount of investment (I) divided by post-money valuation.

⁹ Investor shares = 500,000 * [.5427/(1 - .5427)].

¹⁰ Investment amount divided by number of shares issued to the investors (rounded to nearest cent).

¹¹ In addition to the myriad of business and economic issues that will affect the company's performance, (i) additional investment rounds may be necessary, (ii) additional investment rounds may be “down” rounds in which the preferred stock becomes convertible into additional common shares, and (iii) the company's sale or IPO will be priced based on prevailing market conditions at such time.

¹² A defined term that typically includes a sale or IPO of the company and frequently includes a merger or other fundamental change of the company.

¹³ As if the preferred shares had been converted to common shares (without actual conversion).

Consider the effect of the terms on the following company liquidation scenarios:

Total Sales Proceed	Distribution to Series A Preferred	Preferred Return Multiple¹⁴	Distribution to Common	Common Return Multiple
5,000,000.00	5,000,000.00	0x	0	0
10,000,000.00	10,000,000.00	2x	0	0
15,000,000.00	12,862,000.00 ¹⁵	2.6x	2,138,000	427.6x
20,000,000.00	15,427,000.00	3.1x	4,573,000	914.6x

As the liquidation table demonstrates, the investment valuation and initial ownership percentages are only part of the relevant financial terms. Potential returns to the shareholders may be significantly affected by the terms of the preferred stock.

The effect of future investment rounds (Series B, C, etc.) and the impact of anti-dilution protection provisions are beyond the scope of this paper. The sole purpose of this paper is to illustrate the potential impact of the preferred stock terms on the economic returns to all shareholders.

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¹⁴ The net present value of these return multiples may be calculated as described in footnote 8.

¹⁵ Two times the original Series A investment plus 57.24% of the \$5 million excess on an as converted basis.