Counsel for
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Acredula

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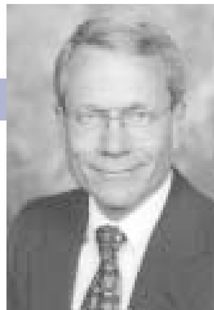
Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

Complex Venture Capital Deals Require More Than A Little Knowledge

When it comes to structuring a venture capital deal, "a little knowledge is a dangerous thing." This month's final installment of our series on raising venture capital discusses selecting a venture capital firm and then structuring a deal. The terms of a venture capital deal are more complex than the terms for most other forms of financing. More than a little knowledge is needed. This issue's feature article reviews the terms of a typical venture deal.

Co-author, Thomas ("Bo") Brownlee, has extensive experience raising capital for small and mid-sized companies.

Editor's Note



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He has guided companies from their emergence, through angel and venture capital financing, to their public or private capital offerings. In addition to assisting clients through the Nasdaq small-cap listing process, he helps clients of all sizes with federal securities filings and disclosures. Bo has additional experience in mergers and acquisitions that often follow venture capital financing.

Raising Capital to Develop Your Venture's Operations

Part II: Presenting Your Business to Venture Capital Firms and Structuring Financing

John P. Beavers and Thomas R. Brownlee, Jr.

Last month's installment of this two-part series focused on planning the development of your business and protecting the resources of your venture. After completing these preliminary steps to raising capital, the next stage of the process involves presenting your business to venture capital firms and structuring venture capital financing. This article provides practical guidelines for preparing your presentation, selecting venture capital firms, determining the amount of capital to raise and structuring financing.

Preparing Your Presentation to Venture Capital Firms

Your presentation to any venture capital firm should focus on those matters that venture capital firms consider important in deciding whether to make an investment.

Most venture capital firms are willing to assume a technology risk. Therefore, your presentation should not be a technical treatise regarding the technology underlying your product and the steps in completing your product development.

Most venture capital firms are less willing to assume an unknown market risk. Most venture capital firms are looking for businesses that offer rapid revenue growth, such as a growth of $100 million over a period of ten years or less. Accordingly, they want your presentation to focus on the size of the market, the potential customers and competitors, and the competitive advantage of your venture in its intended business.

Venture capital firms are investing as much in the human resources of your venture as they are in its technology and ideas. Your presentation should demonstrate that you have protected your resources as discussed in the first part of this series (See February Acredula).

Finally, most venture capital firms are looking for a liquidity event (commonly known as the "exit strategy") returning their investment within three to five years. Such liquidity events include the sale of the business or an initial public offering of the equity of the business. Therefore, you should design your presentation to show a substantial return to the venture capital within this period.

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Selecting Venture Capital Firms for Your Presentation

Begin with some basic research over the Internet or through directories like *Pratt's Guide to Venture Capital Sources* or the *Directory of the Western Association of Venture Capitalists.* Ask for suggestions from other entrepreneurs who have successfully raised venture capital and bankers, lawyers and accountants who work with emerging businesses. Because venture capital firms have become industry and even product oriented in order to reduce technology and marketing risks, look for venture capital firms that have extended capital in your industry or for similar products. Because venture capital firms often limit their investments to businesses within a few hours' drive or direct air flight of the venture capital firm's principal office, look also for venture capital firms that have such geographical proximity.

After you have made a list of potential venture capital firms, interview several. Look for someone to introduce you to those on your list. A referral will often have the effect of a third-party validation of your legitimacy. Also, a referral who personally knows representatives of a venture capital firm can help get and give feedback to you.

When you interview, you are looking for more than just money. First, because the venture capital firm will be your partner for a period of at least three or more years, you are looking for personal chemistry between you and the venture capital firm. Second, you are looking for contacts. Ideally, your venture capital partner will have access to those resources and skills to which you do not.

How Much Should You Raise

Today, venture capital generally or frequently comes in tranches, each for a particular phase of the development of your venture's business. The earliest phase is completing product development to the point of productivity for market. Each phase should have a well-defined milestone. More is better than less because you need to make sure that you can fund your venture not only through unexpected delays, but also until you can complete the next round of financing.

An important limit on what you can raise is the valuation of your business. Most venture capital firms are looking for a tenfold or greater return in five or fewer years. They generally estimate future value based upon a multiple of earnings, usually between ten and 20 times, and then discount that future value using their desired rate of return to a present value of your business. Finally, most venture capital firms want their resulting investment to give them control of 50 to 60 percent of your venture on a fully diluted basis, taking into account employee equity plans.

Finally, conduct research on what valuations venture capital firms are giving to other ventures at the same development stage and in the same general market area as your venture.

What Structure to Expect in Venture Capital Financing

Venture capital financing is typically structured as a form of preferred stock. The selling price of the preferred stock is generally at a substantial premium over relative prices paid by you and other founders for your shares. There are several purposes for the preferred stock. Unlike debt, preferred stock entitles the venture capital firm to capital gains treatment, at least for federal income tax purposes, of any appreciation in

value if your venture is a success. The preferred stock is designed to give a liquidation preference if your venture is less than an ongoing success. The preferred stock has a minimum dividend providing a return on investment as a milestone for measuring the performance of management, and failure to pay those dividends or achieve those or other milestones typically results in increasing the voting power of the preferred stock so that they can replace your venture's board of directors or other management.

The typical preferred stock will have terms similar to the following:

- **Liquidation Preference**. Upon liquidation of your venture, the holders of preferred stock have the right to receive a fixed dollar amount before any assets can be distributed to the holders of common stock. Typically, the liquidation preference is the purchase price plus accrued but unpaid dividends. A "participating" preferred stock also participates with the common stock in the distribution of any assets left after payment of the liquidation preference. The right to receive the liquidation preference is generally triggered not only by a dissolution, but also by any merger into or acquisition by another company.
- **Dividend Preference**. Venture capital preferred stock usually has one of two types of dividend preference. The more common type is the "mandatory, cumulative" dividend which is similar to interest on debt. It accrues at fixed dates, typically annually or not more frequently than quarterly, and accumulates until paid. The second type is the "when, as and if declared, noncumulative" dividend that, in essence, limits your venture from declaring any dividend on common stock until a specified dividend is paid on the preferred stock.
- **Redemption Provision**. The redemption provision may be either a call or a put redemption, or both. A call redemption allows your venture to "call" for repurchase of the preferred stock, requiring the holders to sell, usually at a price equal to its liquidation preference plus a redemption premium. A call redemption generally co-exists with a conversion right, entitling the holders of the preferred stock to either be bought out or to convert to common stock. A put redemption allows the holders of the preferred stock to "put" the preferred stock, requiring your venture to repurchase it, typically at a multiple of the investment made in the stock. A put redemption is normally exercisable only if dividends are not paid or other milestones are not achieved. Redemption provisions are less popular in recent years among venture capital firms because in order to fall within a safe harbor to avoid adverse consequences of possible imputed income, the redemption premiums must be limited to 0.25 percent per year.
- **Conversion Rights**. Generally, the preferred stock is convertible into common stock any time at the holder's option. The conversion right specifies the ratio for the number of shares of common stock into which each share of preferred stock may be converted. In addition, conversion may be automatic upon public offerings of a certain magnitude of your venture's common stock. Sometimes conversion rights are subject to a "pay to play" provision that dilutes the conversion right if the holder does not participate in subsequent funding rounds. With such provisions, the conversion ratio is reduced by the reciprocal of the amount that the holder would have invested if the holder had made a pro rata share of subsequent funding rounds divided by the amount actually invested by the holder.
- **Antidilution Protection**. Preferred stock is typically protected against both "share" dilution and "price" dilution. Share dilution provisions protect the preferred stock against dilution from stock splits, stock dividends, and similar events increasing the outstanding number of shares without the venture receiving additional capital. Price dilution provisions protect against dilution from sales of stock at lower prices. A common antidilution provision is a "weighted average" adjustment of the conversion price or ratio. The weighted average is a formula that takes into account both the number of shares and the capital received of all shares issued over a period of time. An alternative antidilution provision is a "ratchet" that drops the conversion price to the lowest price at which stock was sold over a period of time regardless of the number of shares sold. A problem with the ratchet antidilution is that it protects investors who decline to participate in lower-priced offerings.
- **Voting Rights**. Venture capital preferred stock usually entitles holders to a number of votes at any time determined "as if converted" into common stock at such time on any matter submitted to vote of stockholders. In addition, the preferred stock often entitles the holders as a class to elect a certain number of directors to your venture's board or other governing body, with holders of the common stock electing the remainder. In addition, the preferred stock also entitles the holder to a class vote on certain major corporate events, such as mergers and acquisitions and the issuance of any securities on par or preferred to that class of preferred stock.
- **Registration Rights**. In addition to the foregoing preferences, venture capital firms require participation in

liquidity events available to others, including a right to demand certain events of liquidity so that they can receive a "cash out" of their investment not later than any other investor (See the discussion of "co-sale" rights in the following section). The most common provisions are "piggy-back" and "demand" registration rights. Piggy-back registration rights entitle holders to participate on either an equal or secondary basis in any public offering of securities undertaken by the venture or other security-holders. Piggy-back rights are on an equal basis if the holder can sell a pro rata number of shares with each other holder and on a secondary basis if the holders' number of shares can be eliminated or reduced for marketing or other reasons, as determined by the lead underwriter or investment banker for the offering. Demand registration rights entitle the holders to demand that your venture register their shares for a public offering underwritten by an investment banker chosen by the holders. Typically, your venture pays the related expenses of any such offering other than the underwriting discount or fee which is absorbed pro rata by each seller.

Other Restrictions on Management and Founders

Venture capital financing generally imposes affirmative covenants requiring that your venture provide holders with ongoing financial information, limit compensation of management, and allow access to books and other records. Venture capital financing also imposes negative covenants prohibiting your venture from taking certain actions, such as transferring assets or incurring certain expenses or liabilities, without holders' consent. Your management must carefully evaluate these covenants to ensure that they will not unduly interfere with your board's ability to manage the company.

Venture capital financing imposes a "right of first refusal" on further stock issuances by your venture. These provisions typically give holders the right to buy their proportionate share of any new equity offerings prior to a public offering.

And, as discussed above, venture capital financing generally requires that management and founders give holders a "co-sale" right to participate in any liquidity event proposed by management or founders with respect to their holdings. The purpose of these co-sale rights is to prevent management and founders from "cashing out" without giving holders the same opportunity to participate.

Subsequent Rounds

As discussed above, venture capital financing typically comes in tranches. If the business of your venture is successful with the first round financing, the price received by your venture in the second round will be one and a half to three times the price received in the first round. Businesses are typically valued for second round financings at a multiple of one-times revenues or, if greater. a multiple of ten- to 15-times earnings.

If the business of your venture is not successful with the first round financing, you are likely precluded from subsequent tranches without a change in management or a substantial dilution of management and founders.

Conclusion

Venture capital is a common way of financing the development of your business until it has sufficient operations to support a public offering or attract another form of liquidity event. Planning the development of your business and protecting your resources are requisite initial steps. Careful preparation of your due diligence for potential venture capital firms is also a necessary part of the process. Understanding the possible structure and restrictions imposed by venture capital financing will reduce any surprises. As a result, your venture and the venture capital firm may achieve a partnership that profits everyone.

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