Venture and Institutional Rounds

December 2015
Market environment

• Level of VC investment is down as valuations have hit record highs
  • Late stage companies are attracting a disproportionate share of overall venture funding
  • Many late stage companies are doing follow-on financings
  • Over 80% of capital invested in later stage rounds in 2015 has been in rounds of $25 million or more
Market trends

U.S. VC ACTIVITY BY QUARTER

Source: PitchBook
Market trends (cont’d)

U.S. VC ACTIVITY BY YEAR

Capital Invested ($B)

# of Deals Closed

Source: PitchBook
As of 9/30/2015
Financing Sources
Financing sources

• In addition to traditional venture capital funds, there are many additional institutional sources of capital, including:
  • Family offices
  • Cross-over funds established by mutual fund complexes and/or by family offices
  • Fund affiliates of large technology companies
  • Small business investment companies and business development companies
Term Sheet Issues
Structure of a venture capital investment

• Term sheets
  • Prepared and submitted by lead investor
  • Non-binding
    • Subject to due diligence and execution of definitive transaction documents
    • Confidentiality and exclusivity provisions may be binding
  • Short expiration period
• Term sheet provisions
  • Type of security (e.g., Series C Preferred Stock)
  • Pre-money valuation
  • Investment amount
    • Tranches
    • Subsequent closings (dollar limit and time limit)
  • Syndicate
  • Closing date
  • Pre-closing and post-closing capitalization (cap tables1)
  • Use of proceeds

1 Including any increase to the equity incentive plan reserve (“option pool refresh”)
Structure of a venture capital investment (cont’d)

- Term sheet provisions (continued)
  - Dividend preference
  - Liquidation preference and participation rights
  - Redemption rights
  - Conversion rights (voluntary and automatic)
  - Price-based antidilution rights
  - Voting rights
    - Board composition
    - Protective provisions
  - Registration rights
    - Demand registration rights
    - Piggyback registration rights (with cutback provisions)
    - S-3 registration rights
    - Expenses
    - Lock-up agreement
    - Assignment of registration rights
    - Termination of registration rights
Structure of a venture capital investment (cont’d)

• Term sheet provisions (continued)
  • Information rights
    • Financial statements (monthly, quarterly, annual)
    • Budgets and operating plans
    • Board packages
  • Pre-emptive rights
    • Right of first offer to participate pro rata in future financings
    • Threshold shareholdings required to enjoy right
    • Carveouts
    • Often uses as basis for “pay-to-play” provision
  • Pay-to-play provisions
    • Existing investors must participate pro rata in financing to avoid an undesirable effect on their liquidation preference, priorities and/or valuation differentials
Structure of a venture capital investment (cont’d)

• Term sheet provisions (continued)
  • Right of first refusal
    • Investor opportunity to purchase founder shares before they are sold to a third party
    • May be subordinated to company’s right of first refusal
  • Co-sale rights (“tag along”)
    • Investor opportunity to sell stock to third party alongside founder
  • Voting obligations (“drag along”)
    • Obligation to vote shares in favor of acquisition of company
    • Triggered by vote of requisite constituency, e.g. majority of preferred
    • Eliminates holdouts
Structure of a venture capital investment (cont’d)

• Term sheet provisions (continued)
  • Employee matters
    • Proprietary information and invention assignment agreements
    • Non-compete and non-solicitation agreements
    • Vesting on key employee stock
  • Representations and warranties
    • “Appropriate” or “customary”
    • Company only or company/founders
Structure of a venture capital investment (cont’d)

• Term sheet provisions (continued)
  • Fees and expenses
    • Company pays its fees and reimburses investors up to specific cap
  • Legal opinion of company’s counsel
  • Required insurance
    • D&O
    • Key person life
  • Director indemnification agreements
Preferred Stock Rights
Rights, privileges and preferences of preferred stock

- Waterfall distribution of acquisition proceeds
  - Who converts to common stock?
    - Automatic conversion (e.g., upon majority preferred vote)
    - Voluntary conversion (e.g., share of acquisition proceeds as common stockholder exceeds share of acquisition proceeds as preferred stockholder)
  - Satisfaction of liquidation preferences
  - Participating distributions
  - Distribution of remainder to common stockholders
Rights, privileges and preferences of preferred stock (cont’d)

• Voting rights and protective provisions
  • Preferred votes with common on an as-converted basis
  • Preferred also has separate vote on specified matters
  • Separate vote can be all preferred or by series of preferred, or both
  • Typical series vote
    • Election of specific board seats
    • Any change to the Series rights
  • Class or series vote
    • Approval of fundamental transactions
    • Amendment to charter
    • Additional financings
Rights, privileges and preferences of preferred stock (cont’d)

• Voting rights and protective provisions (continued)
  • Protective provisions on key decisions (by series or by class):
    • Amendment of series or class rights
    • Increase or decrease in authorized number of shares
    • Creation of senior series of preferred
    • Change in board size
    • Declaration of dividends
    • Redemption of stock
    • Incurrence of indebtedness
    • Acquisitions of other companies
    • Sale of company
    • Deviation from business plan, budget or significant expenditures
Rights, privileges and preferences of preferred stock (cont’d)

• Additional contractual rights and obligations
  • Company will typically have contractual obligations to major investors:
    • Preemptive rights on new financing
    • Board observation rights
    • Information rights (financial statements, inspection of books and visitation of premises)
    • Registration rights
    • For strategic investors, right of first refusal (ROFR) or right of first offer (ROFO) on acquisitions
  • Stockholders may have obligations to major investors:
    • Right of first refusal/co-sale rights upon dispositions to third parties
    • Drag-along rights on a sale of the company
Pay-to-Play

• Triggered by failure:
  • Triggered by failure to purchase pro rata share of new financing
  • Reward participating prior investors with preservation of liquidation preferences, priorities, valuation differentials and other rights
  • Punish non-participating investors with loss of liquidation preferences, priorities, valuation differentials and other rights
  • Many different variants (using may different recapitalization mechanics) with many different outcomes
  • Implement through charter-amendments OR contractual exchange
Pay-to-Play – convert to common or shadow preferred

- Convert to common stock
  - Partial conversion vs. “all or none”
  - Existing conversion rate (preserve prior adjustments) or 1-to-1 (eliminate prior adjustments)

- Convert to shadow series of preferred stock
  - Preserve priorities by converting into separate shadow series, e.g. Series A to Series A-1, Series B to Series B-1, Series C to Series C-1
  - Eliminate priorities by converting into a single shadow series, e.g. Series 1 (by shares or by dollars)
  - Deprive shadow series of certain rights (protective voting rights, board seats, antidilution protection, etc.)
Pay-to-Play – complete redesignation

- Redesignate prior preferred into new preferred based upon participation in new financing
  - Nonparticipants converted to Series 1
    - By shares held (preserve valuation differentials)
    - By dollars invested (eliminate valuation differentials)
  - Participants converted to Series A-1, Series B-1 or Series C-1
    - By shares held (preserves valuation differentials)
    - By dollars invested (eliminate valuation differentials)
- Series 1 has juniormost liquidation preference, no antidilution protection and no participation rights
- Series A-1, Series B-1 and Series C-1 preserve priorities, voting rights, board seats, antidilution, etc.
- Sell Series 2
Down Rounds and Recaps
Down rounds – mechanics

- Equity financing at a valuation lower than one or more prior equity financings:
  - Series A invests at $1.00 per share
  - Series B invests at $2.00 per share
  - Series C invests at $3.00 per share
  - Series D invests at $0.50 per share
  - Series D gets 2X the ownership interest of Series A per dollar invested, 4X the ownership of Series B and 6X the ownership interest of Series C
  - Rather than give Series A, Series B or Series C more shares, we simply adjust their conversion rates into Common Stock (voting, dividends and distribution of acquisition proceeds are on an as-converted basis)
Down rounds – antidilution

• Antidilution Adjustments:
  • Conversion rates of prior preferred are adjusted according to formula
  • Golden Rule: investors in down round must acquire an ownership interest equal to the portion of the post-money valuation attributable to their investment (e.g. 20% ownership in exchange for a $2 million investment at an $8 million pre-money valuation)
  • Beware of “death spiral”: conversion rate adjustments must be taken into account when computing price per share in down round
Down rounds - conflicts

• Conflicts of interest if insider-led:
  • Fiduciary duty of director vs. self-interest of investor
  • Statutory procedures for interested director transactions (disinterested director approval and/or disinterested stockholder approval)

• Reducing litigation risks:
  • Disinterested lead investor in new financing (if possible)
  • Clear record of thorough search for disinterested lead investor
  • Rights offering to all affected stockholders
  • Disinterested approval of special committee of board of directors
  • Disinterested stockholder approval
Recapitalizations – mechanics

• Structured for their desired effects on:
  • Liquidation preferences (preserve or eliminate)
  • Priorities (preserve or eliminate)
  • Valuation differentials (preserve or eliminate)
Recapitalizations – “valuation reset”

• “Valuation Reset”
  • Redesignate all prior preferred into Series 1, Series 2 and Series 3 by dollars invested in prior preferred
  • Sell Series 4
  • Preserves liquidation preferences
  • Preserves priorities
  • Eliminates valuation differentials (favored by Series 4 investor that seeks most favorable treatment for its prior investment at high valuation)
Recapitalizations – “preference reset”

- “Preference Reset”
  - Pro rata reduction in liquidation preferences of some or all prior preferred
  - Sell next series
  - Reduces liquidation preferences
  - Preserves priorities
  - Preserves valuation differentials
  - Reduces “preference overhang” over common stock
Recapitalizations – “wipeout”

• “Wipeout”
  • Automatically convert all (or some) preferred into common
  • Sell Series 1
  • Eliminates liquidation preferences
  • Eliminates priorities
  • Prior investors end up in same position as employees
Planning Ahead
Planning ahead for the issuer

- Due diligence and corporate housekeeping
- Employment agreements and option pools for management and for new hires
- Intellectual property issues
- Board composition and legacy holders
- Liquidity for angels, friends and family
- Realistic valuation expectations
Investor planning

- Institutional investors are focused on
  - Time to liquidity or exit
  - Likeliest exit for the particular issuer
  - Acquisition price protection and an ability to influence an M&A exit
  - IPO price protection; “qualifying IPO” definition, IPO valuation
Exit Trends
Exit trends

U.S. VC EXITS BY QUARTER

Source: PitchBook
Exit trends (cont’d)

U.S. VC EXITS BY YEAR

Source: PitchBook
*As of 9/30/2015
Exit trends (cont’d)

VC EXITS & CAPITAL EXITED BY TYPE

Source: PitchBook
As of 9/30/2015