Early-Stage Companies:

Understanding Venture Capital

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Overview

Business owners of early-stage companies are often overwhelmed by the complexity associated with securing venture capital funding. The process is not easy. Nor should it be undertaken without the appropriate advisors in order to protect your interests in the company now and in the future. This primer is designed to provide a general overview of what business owners need to consider when undertaking a capital raise from a venture source.

It will outline the stages of venture capital funding, what sources of funding are available, and best practices for understanding the legal and financial terms of each funding source. We have also included a variety of external resources for business owners to review in order to gain more insight into the process.

1. Stages in Venture Capital Investing

› STAGES IN VENTURE CAPITAL INVESTING

There are four main stages to venture capital funding each with uniquely different sources of funding:

1. **Seed or Concept Stage Capital** is designed to build infrastructure for a business including management, business plan, market studies, commercial feasibility of a product or service, fund initial research and development, and some operating expenses. This capital is usually raised when a company has not secured any revenue.
2. **First Stage Capital** is put into place when a company is offering products or services and is no longer pre-revenue. Some of the management is in place, the business plan is being refined, and the company has started to brand itself.
3. **Second Stage Capital** is obtained only after the company is achieving growth in both its balance sheet and its revenues. Usually companies that reach this stage are at or above the break-even point of their operations. Additionally, a seasoned management team is usually in place and attention has turned to expanding operations and sales geographically.
4. **Third or Fourth Stage Capital** is secured when the company is operating profitably and achieving scale in its operations, beginning to expand its products or services, and continuing its expansion geographically to build its brand.

Business owners must understand the expectations from venture funders for each of these phases. As discussed on the next page, the sources of funding are very different and in order to secure the desired capital it is critical that certain requirements are met.

› EQUITY AND DEBT FINANCING RESOURCES FOR EARLY STAGE AND GROWTH COMPANIES

- **Attorneys**
- **CPAs**
- **Investment Bankers**
- **Local Venture Capital Investors**
- **Regional Venture Capital Investors**
- **Business Accelerators**

Sources of Funding by Venture Capital Stage

1 Seed or Concept Stage

- Sweat Equity
- Personal Savings
- Personal Loans
- Friends and Family

2 First Stage Capital

- Accelerators or Incubators
- Venture capital funds (Series A investments)
- Family Offices
- Government Grants
- Equity Crowdfunding
- Non-Bank Loans
- Leasing Companies
- Strategic Partnerships
- Venture Debt

3 Second Stage Capital

- Venture capital funds (Series B investments)
- Some Private Equity Funds
- Strategic Partnerships
- Commercial Loans from Traditional Banks
- Leasing Companies

4 Third/Fourth Stage Capital

- Private equity funds
- Senior debt Financing from Commercial Banks
- Subordinated Debt
- Unitranche or Term A and Term B Senior Secured Debt
- High Yield Debt

2. Understanding Equity Debt or Convertible Debt Timing and Impact

There are several considerations that go into the timing and impact of equity debt or convertible debt.

First, there needs to be close attention paid to pre-money valuations and cash burn rates on amounts of equity to be raised. Equity can either be subscribed and fully funded at the closing of a subscription, or equity can be subscribed but contributed in tranches. In other words, when the company meets certain milestones. A major difference in the second option is that investors are able to lock in pre-money valuation at the subscription but a portion of that subscription can be forfeited if the milestones are not reached and the funding does not occur.

Convertible Debt is generally issued when a founder of a company is unwilling to accept the level of dilution that would be required based on the owner's view of valuation versus and investor's view of valuation. Coupons generally range from six to eight percent and terms are run from 18 to 24 months with acceleration of the conversion option in the event of a follow-on equity raise. Conversion rates are normally 70 to 85 percent of fair market value as of the conversion date with 80 to 85 percent being most common. Some convertible debt instruments have valuation caps on the fair market value of the company as of the conversion date.

Venture Debt, on the other hand, is generally issued in support of institutional venture capital funded companies. There are no financial covenants and usually it is for a three year term which is supported by venture capital Series A funding. Importantly, there is no equity dilution other than warrants in some cases and they can be subordinated to senior debt first lien UCC filings.

Other Subordinated Debt is generally issued in lieu of equity by companies that have sufficient cash flow to fund an interest coupon periodically and are willing to issue high interest rate debt in lieu of equity. These coupons generally range from 11 to 13 percent and are paid periodically, often quarterly. Terms last around five years and are subject to applicable high yield discount obligation (AHYDO) rules and include some type of return enhancement such as paid-in-kind interest or warrants.

3. Glossary Terminology and Deal Documentation

Term Sheet

- Non-binding summary of terms of a specific transaction. The exception being certain binding terms such as confidentiality, exclusivity period, and costs.
- Ideally, companies should solicit funds from multiple sources resulting in multiple term sheets from which to choose.

Term Sheet Considerations

Valuation and Dilution: The impact of unissued options and warrants on fully diluted number of shares outstanding after the issuance of new shares.

Dividend on Preferred Stock Issuances: Can be cumulative (compounded or non-compounded if accrued and unpaid), non-cumulative, or preferred pari-passu with common.

Liquidation: Can be equal to the amount paid for the stock or equal to a multiple of the amount paid for the story (i.e. 2x or 3x). Companies electing the participating preferred liquidation preference pays liquidation preference on preferred shares and permits the payout of a portion of the remaining proceeds as if the preferred shares had been converted to common shares. Non-participating preferred liquidation pays only preferred liquidation preference.

The participating preferred liquidation preference is subject to a cap (i.e. a multiple of the original investment).

Conversion Rights of Preferred Stock: Voting on an "as converted" basis.

Voting Rights and Protective Provisions: See Voting Agreement definition below.

Anti-Dilution Provisions: Numerous provisions options which protect against "down round" where the value of the company is below the original purchase price of the preferred shares. A full ratchet-reduction of the conversion price of the shares issued in a "down round" to the issuance price of the new shares allows transfers of all of the dilutive impact of the new share issuance to the common shareholders.

Weighted average: Converts the conversion price of the preferred shares to the weighted average per share value of the original shares and the newly issued shares. No price-based-preferred shareholders bear the risk of a "down round" pari-passu with common shareholders.

There are several carve-outs to anti-dilution provisions including the following:

- Stock issued as dividend on preferred stock
- Stock issued upon conversion of a convertible note, warrant, or option
- Stock splits
- Equity compensation grants
- Warrants issued to debt holders
- Stock issued as part of an acquisition

Pay to play provisions can also be an option when an investor does not participate in a subsequent round of capital raised. The anti-dilution provisions will not apply to share issued in that raise.

Redemption Rights (Put Provisions): Can be expressed based on the passage of a certain time period, generally five years but occasionally as long as seven years. They can also be tied to achievement of a certain valuation level but this is undesirable because of liquidity issues.

Registration Rights: Demand registration rights permit holders to require registration after passage of a period of time such as from the date of the investment or after an IPO. Piggyback registration rights enable holders to participate in the registration of shares.

Pre-Emptive Rights: Permit pro-rata purchase of subsequent share issuances and does not apply to carve-outs noted above.

Co-Sale or Drag Along Rights: See Right of First Refusal and Co-Sale Agreement definition below.

Management Rights: See Management Rights Agreement section below.

Founder's Shares: Depending on the reasons for a founder's departure, including compliance with terms of an employment agreement, the valuation of those shares could be affected.

Stock Purchase of Subscription Agreement

- Details of the stock subscription, including number and class of shares subscribed, payment terms, milestones affecting subscription payments, representations, and warranties about the company.

Certificate of Incorporation or Articles of Incorporation

- Includes rights associated with the various classes of shares and procedure for the issuance and transfer of shares, among other issues.

Investor of Shareholder Rights Agreement

- Typically includes investor protections, including consent rights and rights to Board representation.

Voting Agreement

- Governs rights to increase the number of authorized common shares, determine Board participation, and approve certain corporate actions (often requiring super-majority approval). Normally the agreement provides for the conversion of preferred shares to common for purposes of voting, with the vote based on the "as converted" number of shares.

- Super-majority approval or the vote of a majority of Board members appointed by investors, could be required for actions such as the following:

  (a) Liquidation
  (b) Issuance of new stock with rights senior to preferred stockholders (or at parity)
  (c) Issuance of debt in excess of pre-determined amounts
  (d) Redemption of stock
  (e) Board changes
  (f) Purchase of assets in excess of pre-determined amounts
  (g) Acquisitions of the stock or assets of a company
  (h) Authorization of loan transactions with officers and directors or Board members
  (i) Material changes to the compensation of the management team
  (j) Transactions not in the ordinary course of the company's business

- Care should be taken in negotiating voting rights affecting governance provisions as some of these provisions could adversely affect Board-management relationships and the efficient operations of the company.

Right of First Refusal and Co-Sale Agreement (Drag-Along Rights)

- Requires certain stockholders to agree to a sale of the company if certain conditions are met, often if 51 percent of the as converted shares vote in favor of a sale, but in some cases a higher percentage such as 66.7 percent.

- May require Board approval

- May require a certain percentage of common share approval in addition to the preferred shares.

- May provide for a minimum price in order to be effective.

- Applies to merger or consolidation, sales of substantially all of the assets of the company, and/or sale of voting control.

- Consider the impact of drag-along rights on joint and several liability versus several liability. Dragged along shareholders should negotiate for several liability.

Management and Information Rights Agreement

- Relates to ERISA fiduciary rules, which do not apply to venture capital operating companies and investment in operating companies in which the fund investor obtains management rights. As such, this agreement creates these contractual rights which permit the fund investor to meet the fiduciary exemption. The rights in these agreements generally include receipt of applicable financial data, inspection rights, and the right to discuss business issues with management.

Indemnification Agreement

- Generally permit indemnification of the investor and any Board members appointed to the company's Board by the investor, typically a private equity of venture capital fund. These agreements will generally address the priority of indemnification liability between the company and the fund investor.

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Carroll represents numerous closely-held businesses in the foodservice distribution, manufacturing, construction, retail, wholesale, and service industries, as well as private equity and venture capital funds. Many of these businesses are second and third generation family owned and operated businesses. Carroll's services in the mergers and acquisitions area include valuation, interaction with investment banking firms and law firms during all stages of negotiations, structuring transactions, tax planning and modeling of after-tax cash flows from various transaction structures, due diligence assistance, and negotiation of various terms of the transaction.

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