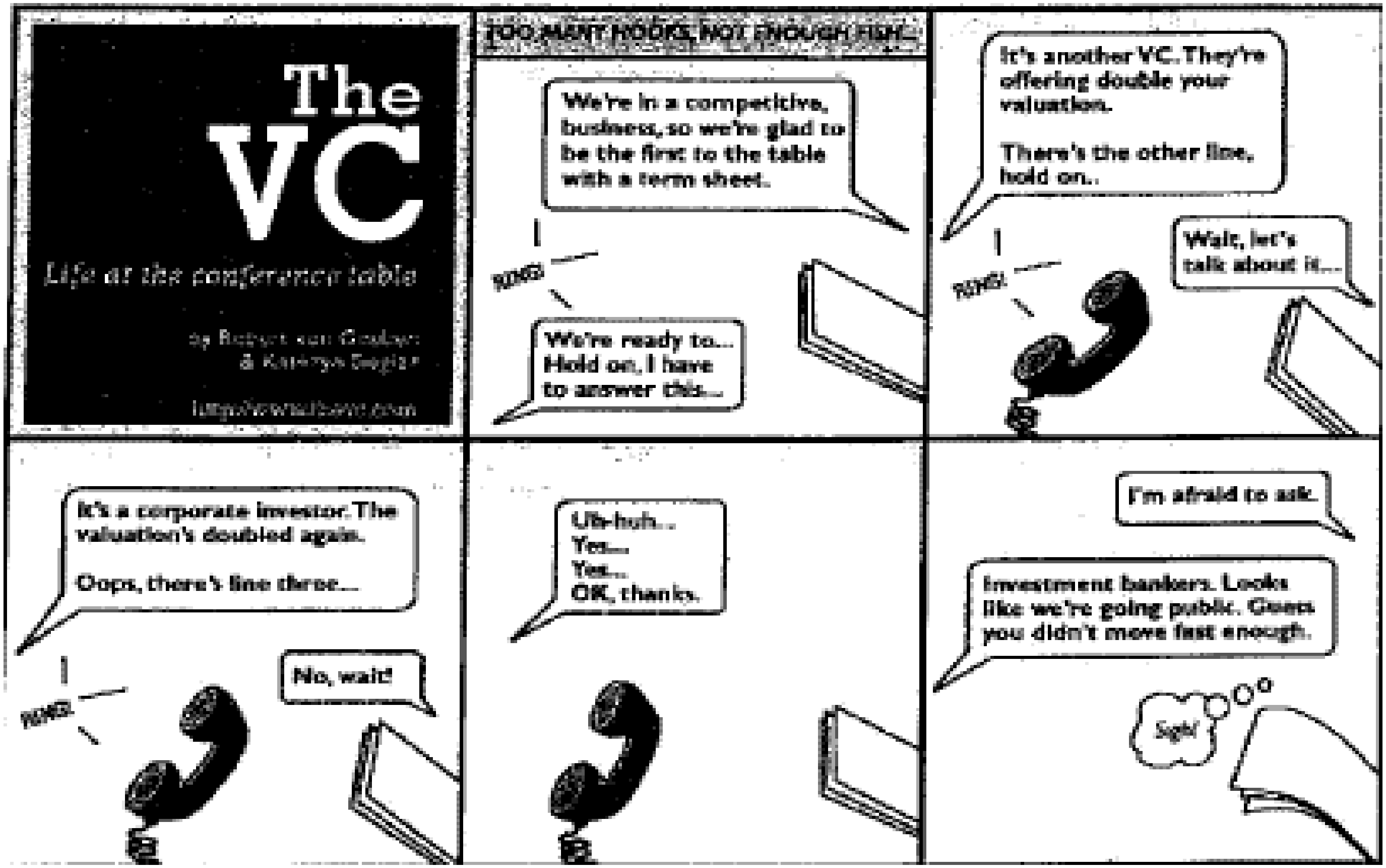
NASVF Annual Conference

September 18, 2007

The good old days …?



Why do we use term sheets?

- **Uses a language remotely close to English**
- **Get major deal points agreed before going to legal docs**
  - Getting lawyers involved starts the real costs
  - Lawyers are deal-centric
- **Sometimes triggers a financing event (bank/bridge loan)**
- **Term sheets are generally non-binding, *except*:**
  - Standstill, confidentiality, costs
- **<u>But</u>, the VC's reputation on the line**

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Be balanced, but aggressive

- **Tailor the deal to the situation:**
  - Risk profile and growth plan
  - Milestones to be achieved
- **VC deals are a balance between:**
  - Risk: Impose consequences if company misses plan
  - Reward: Be sure to get paid if company does well
- **Most LPs have slated private equity as the riskiest part of portfolio – be risky**
- **Pick your battles – abusive tactics will ruin your relationship and reputation**
- **Harping on downside protection doesn't make returns**
  - But still important in today's market
  - Maintain control to foster success

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What Entrepreneurs Claim to Care About

- **Price**
  - Pre- and post-money valuations
  - Post-deal cap structure is what matters
- **Stock Vesting**
  - When is the stock theirs forever
  - How to make it watertight (subjective wiggle room)
- **Who's in Control?**
  - Board makeup
  - Veto protective provisions

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What Entrepreneurs Should Care About

- **VC's ability to help company grow**
  - Experience with startups, contacts, customer assistance
- **Industry operating experience can be a negative**
- **VC's reputation for trust, honesty, good treatment of entrepreneurs**
- **VC's ability to give company sufficient attention:**
  - Location, fund size, fund life cycle
  - Internal dynamics: desperate for exit? Succession issues? Distracted by fundraising?
- **VC's ability to facilitate an exit – Generate Returns**
  - Most VC returns come from a handful of funds

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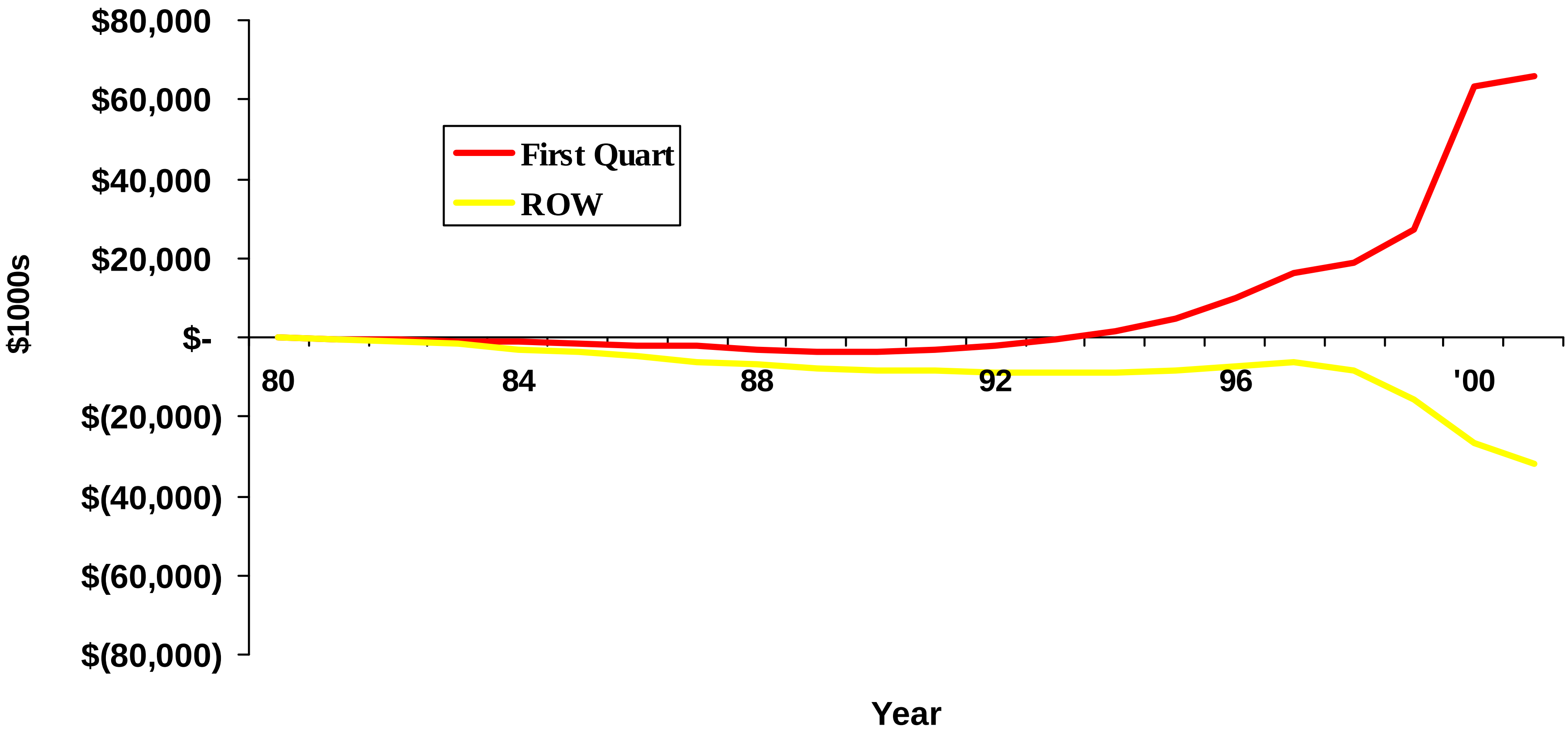
Top Quartile Funds Make Money



Still a Good Asset Class – if You're Risky

Fund Type	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**	**20 Yr**
Seed Stage VC	***6.8%***	***-0.2%***	***-4.0%***	***0.8%***	***10.7%***
Early Stage VC	***8.0***	***7.2***	***-1.3***	***40.0***	***21.5***
Balanced VC	25.4	12.3	5.8	18.0	14.3
Later Stage VC	23.5	9.6	5.2	10.0	13.8
All Venture	18.1	9.6	2.7	21.0	16.4
NASDAQ	3.5	6.7	5.6	7.1	9.0
S&P 500	9.7	8.1	4.4	6.5	8.2

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Binding term sheet terms

- **Standstill**
  - Company agrees to stop talking to other investors for 30-60 days period
  - Helps VC negotiate deal unrushed … But company needs an out if the deal gets derailed
- **Confidentiality**
  - Not just the terms but the existence of the term sheet is taboo
- **Expenses**
  - Company pays investors’ legal fees, even if deal falls through (negotiable if investor walks for no reason)
  - Try to negotiate a cap!
- **Expiration Date**

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Two most typical financings

- Convertible Notes

- Convertible Preferred Stock

Convertible Notes: Two Scenarios

- **Seed Financings**
  - Designed to help seed stage company through initial concept phase
  - Inception capital, cheap, contingent, heavy sweeteners

- **Bridge Financings**
  - Bridges company to the next fundable milestone
  - Don’t let your bridge turn into a pier

- **Understand the purpose of the bridge and stick to it**

Why use Notes?

- Cheap and fast
- Delays the need to price the company until a value-related event occurs
- Sometimes secured (bridge), sometimes not (seed)
- Sometimes tranched with draw takedowns
- Companies like it: Chance to improve price before issuing any equity
- Investors like it: Senior debt status, reserves seat at equity round, sweetener could be meaningful

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Note Terms

- **Interest Rate**
- **Maturity Date**
- **Conversion Sweetener**
  - Conversion discount, warrants, or both
- **Pre-Conversion Sale Sweetener**
  - Return multiple, warrants, or both
- **Secured by company assets (IP could be valuable)**
- **Tranche takedowns**
  - Not meaningful without clear, objective draw triggers
  - VC will always try to negotiate some subjectivity in

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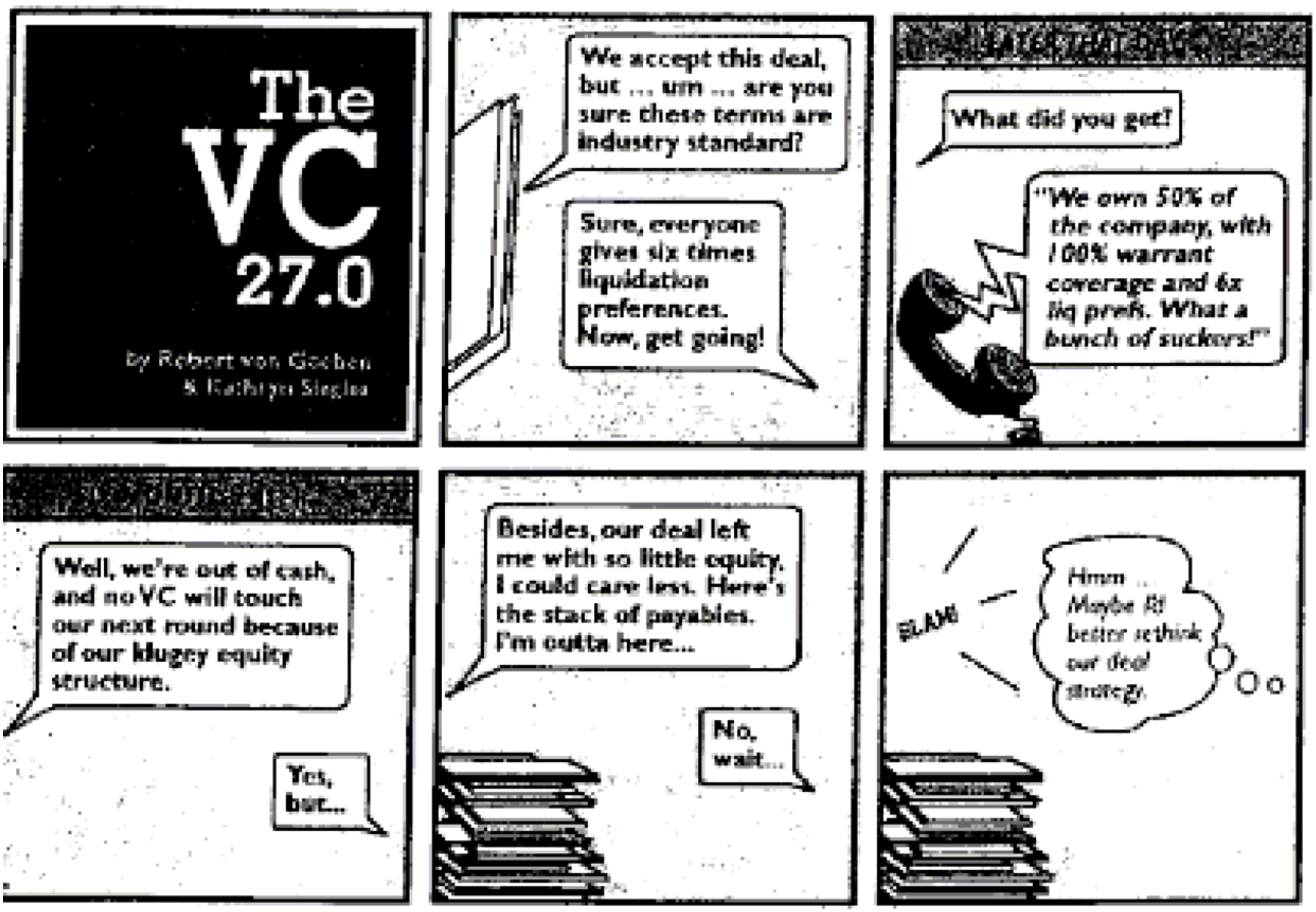
Preferred Stock Terms



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Preferred Stock Key Terms

- Economics
- Economic Kickers / Hedges
- Closing conditions
- Dividends
- Liquidation Preference
- Founder Terms
- Voting
- Board Composition / Powers
- Tranching
- Anti-Dilution
- Pay to Play
- Right of First Refusal & Co-Sale Rights
- Drag Along Rights
- Employee Terms
- Management Carve Outs
- Information Rights
- Other Terms

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Economics

- **What % of Company for how much $**
  - Pre- and Post-money valuations
- **How to split up the company among:**
  - Founders
  - Previous / Angel investors
  - New investors
  - Employees (present and future)
- **Minimum chunk for lead investor who presents TS**
- **Be sure to incentivize anyone who can help company**
- **What drives valuations?**

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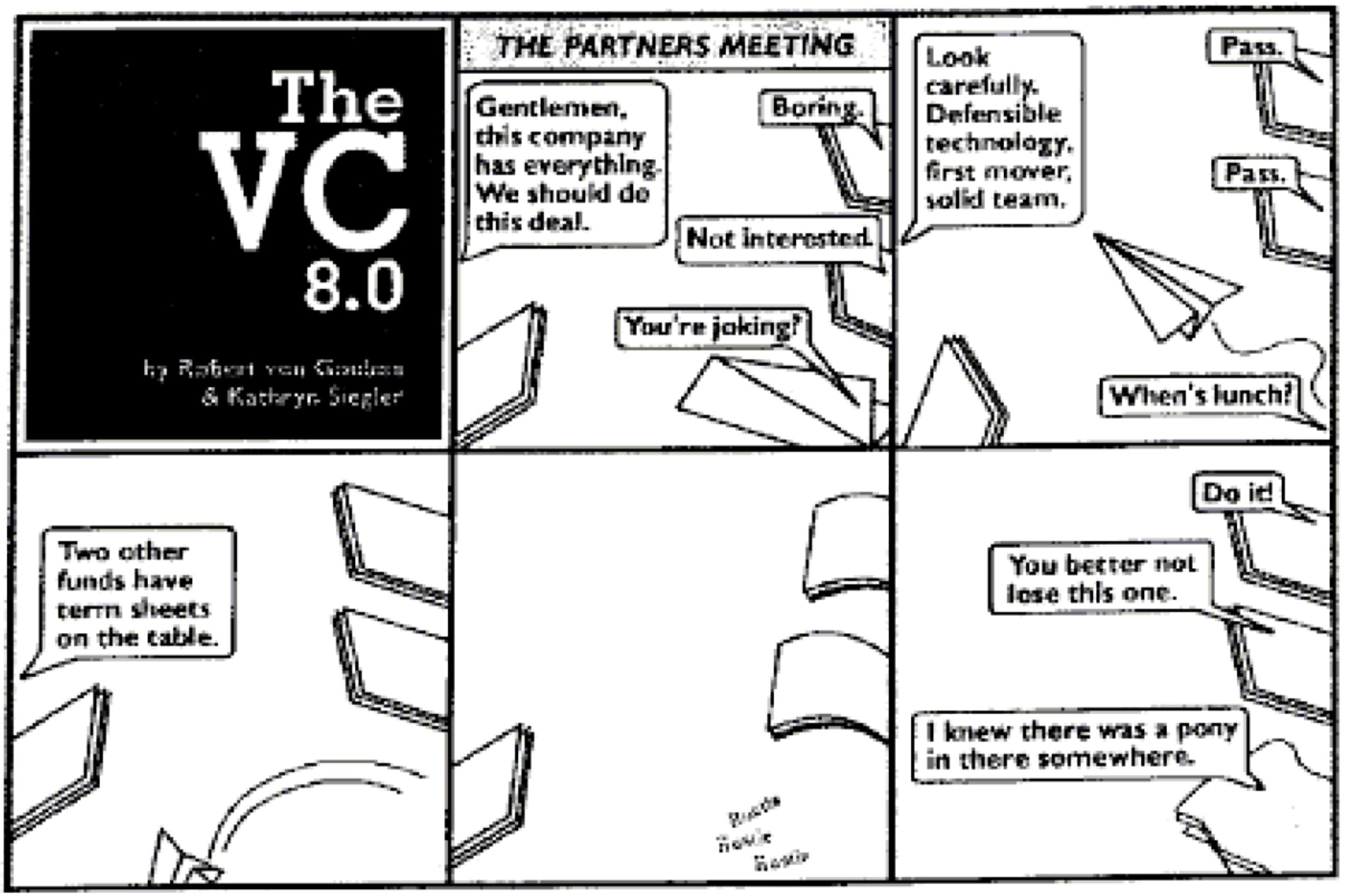
What drives valuations?



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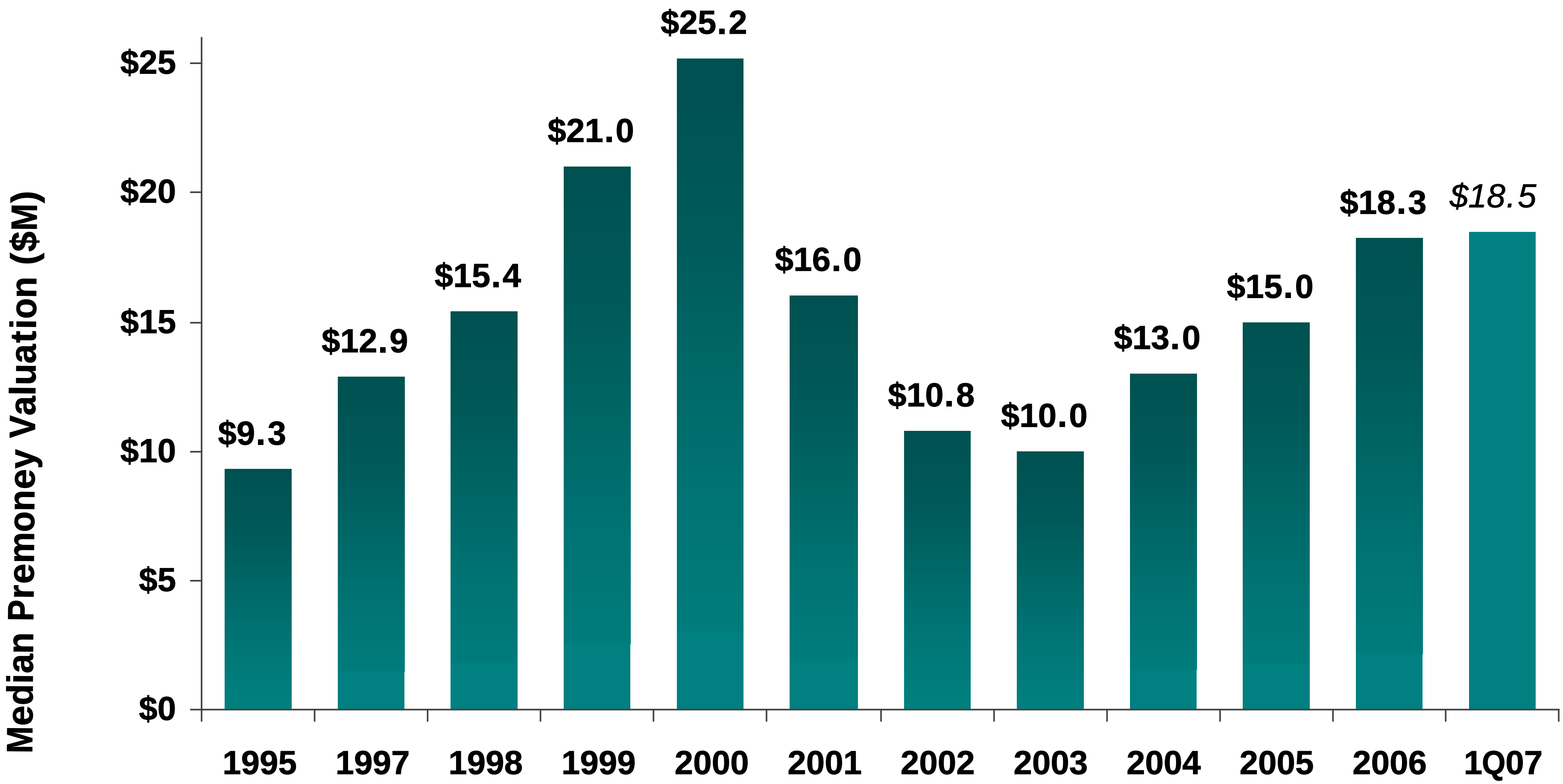
Valuations Hold Steady at 2006 Levels

Median Premoney Valuation by Year



Economic Kickers / Hedges

- **Warrants**
  - Warrant Coverage: X% of investment / strike price
  - Term
  - Underlying security and strike price
  - Be sure to allocate part of purchase price to warrants
- **Post-deal price adjustments**
  - Helps bridge pre-money value gap
  - "If you miss milestone X, then":
    - Conversion price adjusts to Y
    - Second tranche comes in at lower value
  - Mitigates litigation and indemnification risk

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Liquidation Preference

- **Sets up the preferred holder pecking order**
- **Likely exit scenarios:**
  - IPO
  - Redemption
  - Euthanasia
  - Liquidation Event (M&A): Only case where preferences matter
- **Gives Preferred benefits of both debt and equity**
  - Holders get money back first (sometimes multiple)
  - Typically also play pro rata in residual value

Liquidation Preference

- **Variations**
  - Non-participating preferred
  - Full participating preferred
  - Time gated participating preferred
    - Preference diminishes over time
    - Incentive to company to shoot big and not sell early
  - Dollar capped participating preferred
    - Preference doesn’t apply if exit without it gets VC X times return
    - Argument: Preferences are downside protection. Common stock should reap all benefits if the company is a homerun.
  - Preference multiples

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Liquidation Preference: Example

- **VC invests $1M for 20% of company, but gets 3X participating liquidation preference**
  - Post-money valuation = $5 million
- **Sell company for $20M**
  - VC gets 3X preference back first = $3 million
  - VC gets 20% of remaining $17M = $3.4 million
- **<u>Result</u>: VC receives 32% of proceeds ($6.4M) while only owning 20% of the equity**
  - Equivalent to setting the initial post-money at $3.1 million instead of $5 million!

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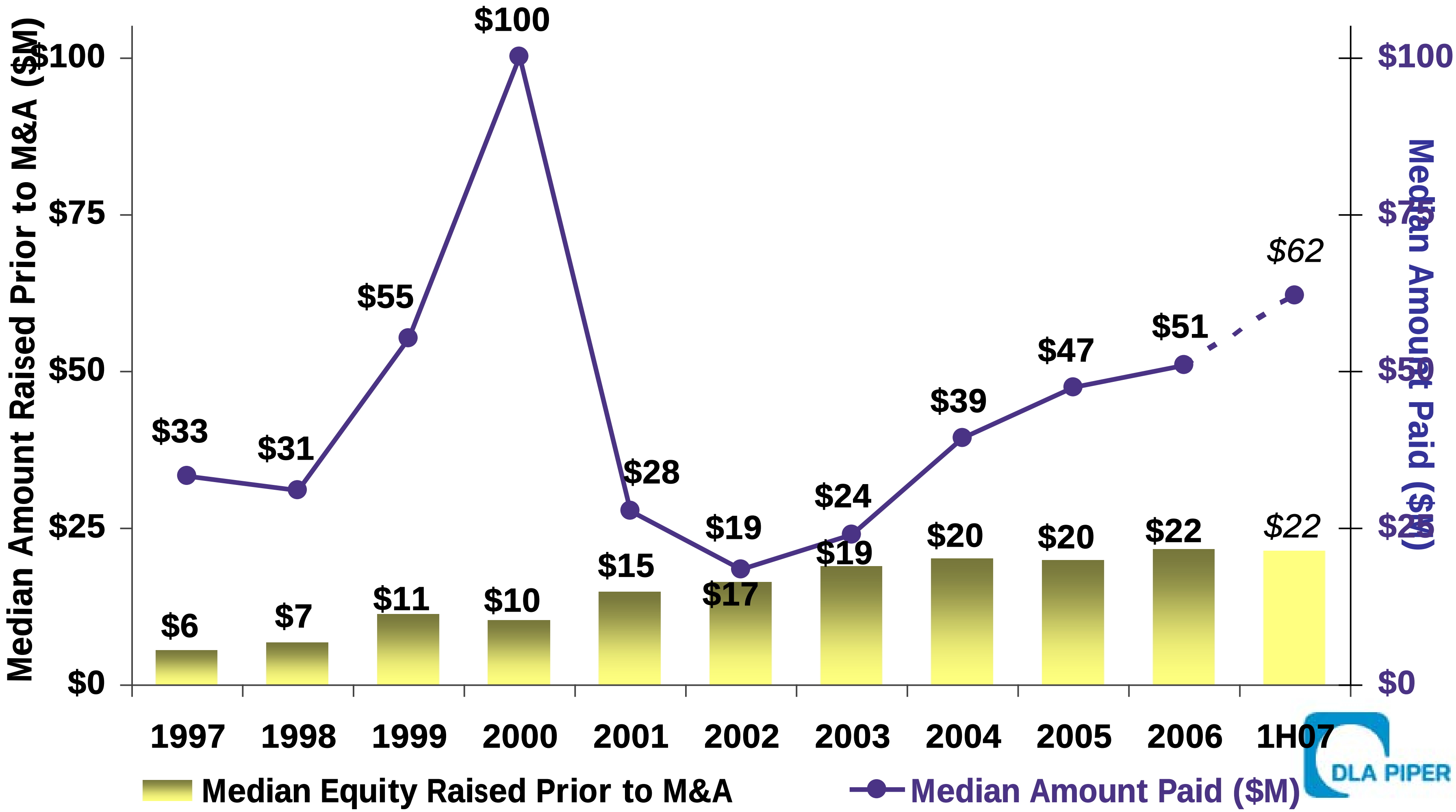
Preferences matter more than they used to

Median Amount Paid vs. Amount Invested

- Only about a 2x return in 1H06
- Median barely broke even 2002 and 2003



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Founder Terms

- **Investors will impose vesting**
- **Typically structured as buy back right**
  - Company can repurchase unvested portion of founders' stock (lesser of cost or FMV)
  - Founder has full voting rights until buyback invoked
- **Invention assignment, NDA, Non-compete, Non-solicit agreements**
  - Tough to enforce if not carefully drafted
- **Be sure founder files 83(b) election when restricted shares are issued**
- **Be sure to prepare 409A written report to validate share price**

Founder Terms

- **Innovative New Structure: FF Preferred Stock**
- **Issued at Company formation in lieu of Common**
- **May convert FF Stock into subsequently issued preferred stock**
  - Conversion is optional and must be approved by all
  - Must be converted immediately before a new round of funding
  - All or any portion may be converted
- **Immediately after conversion, holders sell converted stock to investors as part of the round**

Board Composition

- **Makeup: Split b/w common & preferred**
  - Who loses a seat for the CEO?
  - Independent director critical – how chosen?
- **Basic Structure – Voting Rights**
  - Certain protective provisions pushed to board level
  - Common may have more influence
- **Composition set forth in the term sheet**
  - All shareholders agree on how to vote at closing in Voting Agreement
- **Failure readjustment**
  - Investors may pre-negotiate right to take over majority of the board under certain circumstances
- **Committee memberships**

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Pay to Play

- **Any investor who doesn't participate pro rata in subsequent financing rounds is penalized**
  - Lose anti-dilution protection
  - Proportionate or full conversion of preferred to common
  - Subsequent down round could wipe out non-player
- **Purpose:**
  - Good term for the company – encourages investment
  - Bad term for non-lead investors, particularly small funds surrounded in a big fund syndicate
  - Investors must anticipate company's future funding needs
  - Maintain sufficient reserves

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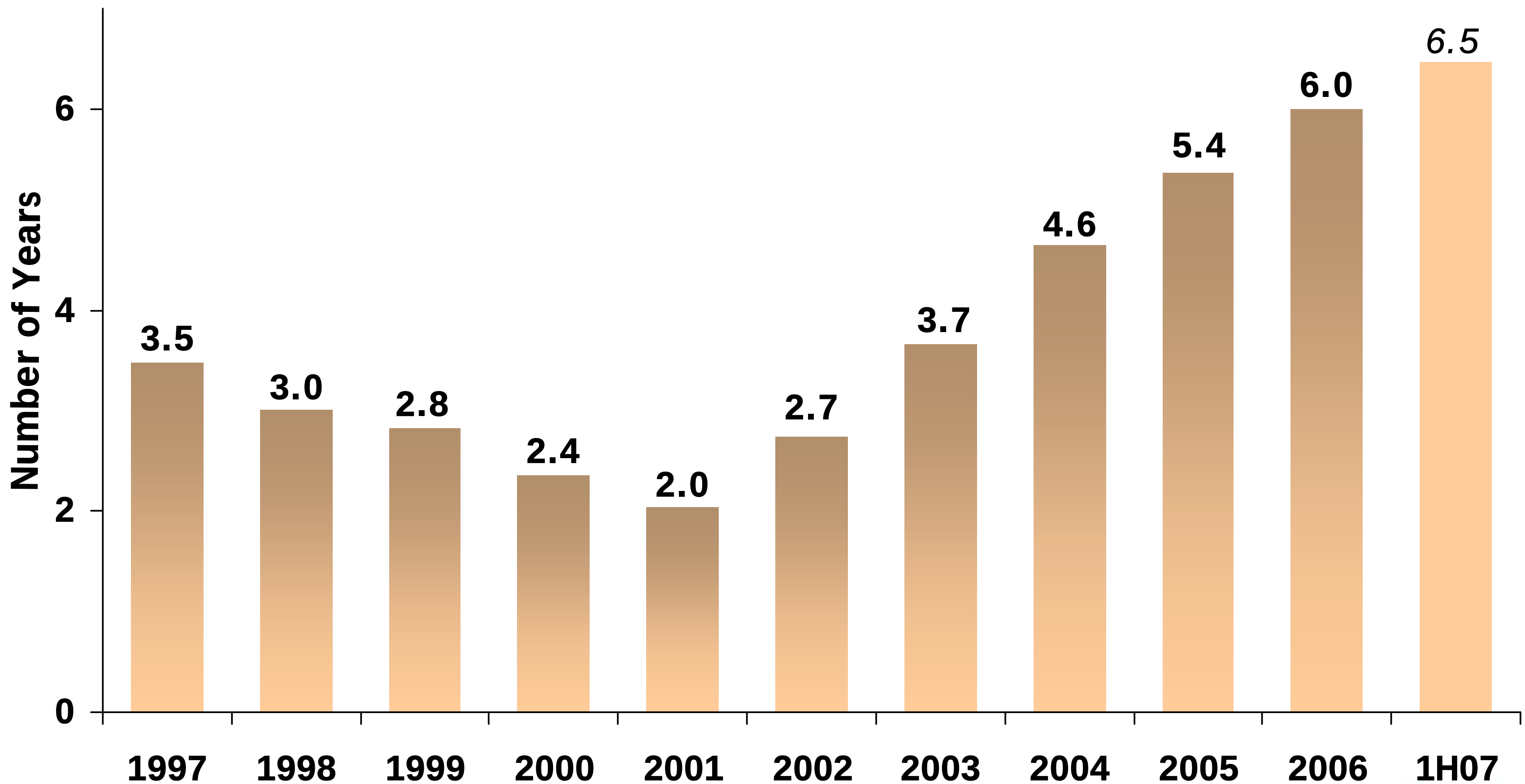
Pay to Play

- **Increasingly common as time to exit increases**
- **Recent Delaware Case Law**
- **How to make sure your pay to play is enforceable?**
  - Treat all investors the same
  - Provide full and accurate disclosure to all
  - Give all investors sufficient time and opportunity to participate
  - Impose penalty on investor only at investor's election not to play
  - Follow strict corporate procedures – document everything

Longer Time to Exit

Median Time from Initial Funding to M&A Exit

- Most companies bought today were founded in 2000
- Critical component when choosing a VC investor



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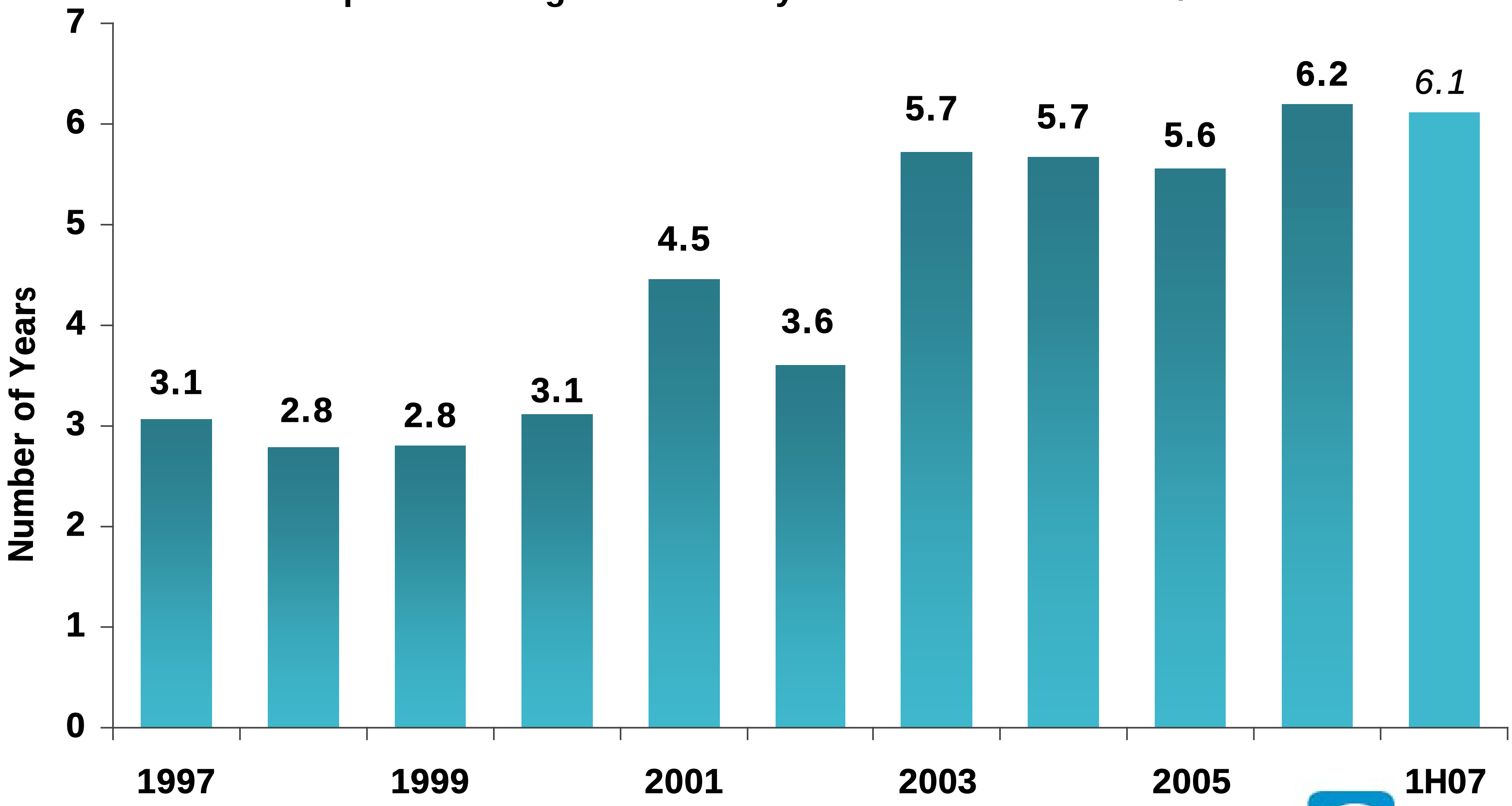
Similarly Long Time to Reach an IPO

Median Time from Initial Investment to IPO

- Most Companies Going Public Today Were Founded in 2000/2001



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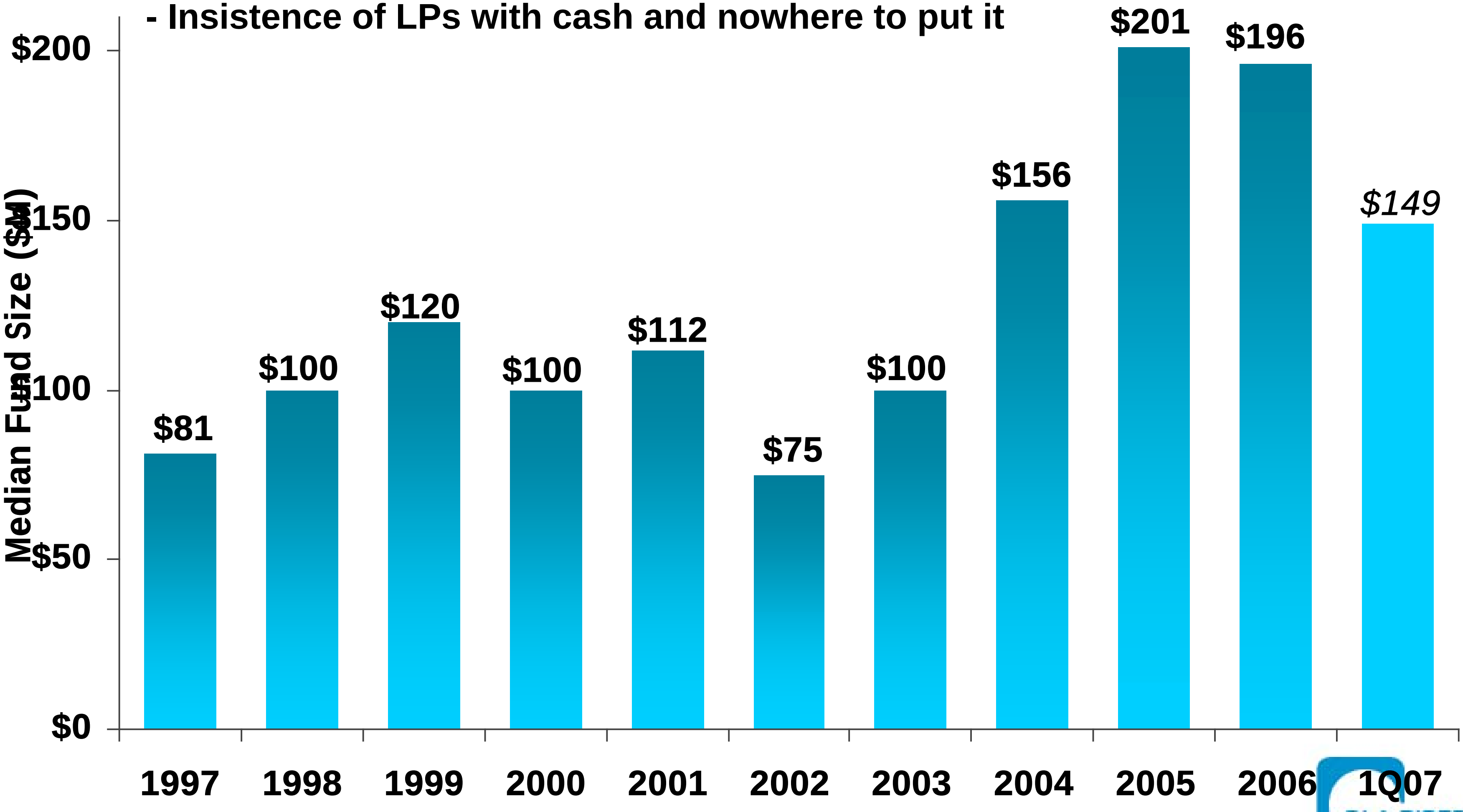
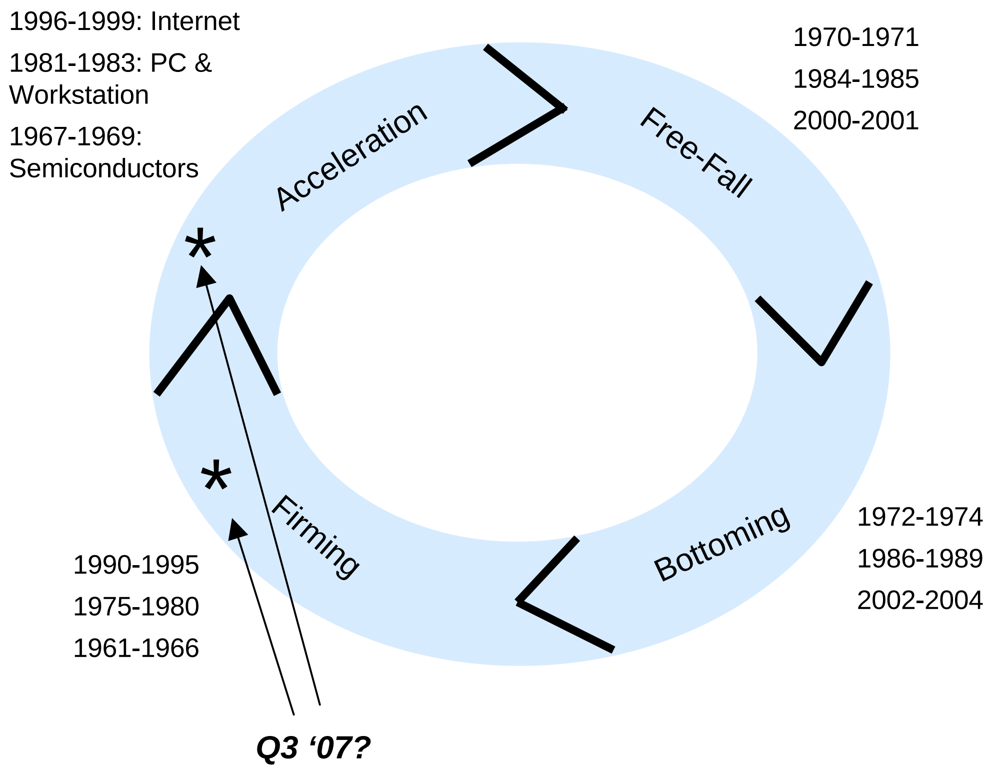
Fund Size Historically Large

Median VC Fund Size Growing Dramatically

- Longer time to exit
- Pay to play regularity
- Insistence of LPs with cash and nowhere to put it



Negotiate Intelligently in Market Context



Peter Wagner, Accel Partners:

- **Recurring cycle based on market's psychological comfort with risk**
- **"Firming" period often when great companies get started**
  - **Apple (1977)**
  - **Microsoft (1975)**
  - **Amgen (1980)**
  - **3Com (1979)**
  - **Cascade (1990)**
  - **UUNet (1990)**
- **"Acceleration" period should arrive when today's seeds are ready for harvesting**

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Questions

Jeffrey Leavitt
404-736-7818
jeffrey.leavitt@dlapiper.com