SAN DIEGO
Angel Conference

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CAPITALIZATION & TERM SHEETS: THE NEED TO KNOW

MINTZ

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Authorized Shares

- This is the largest possible capitalization bucket – it's the total number of shares which are authorized under the Articles/Certificate of Incorporation
- Needs to include
  - All outstanding shares of Common Stock
  - All outstanding shares of Preferred Stock **and** the shares of Common Stock issuable pon conversion
  - All options and warrants, whether or not vested
- May not include convertible notes/SAFEs – these may not be calculable until the financing terms are negotiated
- Changing authorized shares requires an amendment to the charter

Fully Diluted Shares

- These are shares that are outstanding or which could become outstanding (e.g., options and warrants after exercise)
- May or may not include convertible notes or SAFEs depending on whether the number of shares can be determined
- Includes the available option pool
- Is the basis for calculating the price per share in a financing
- When a company commits to issuing x% of the capitalization (e.g., an option grant to an advisor for 0.1% of the capitalization), this is typically calculated using fully diluted shares

Issued and Outstanding Shares

- This is the smallest bucket, and only includes outstanding shares of Common and Preferred Stock
- Does not include any options, warrants, convertible notes or SAFEs
- Used to determine the voting rights and for any dividend payments to shareholders

Cap Table v. Ledger

- The ledger is the underlying record used to generate a cap table
- A ledger has detailed information about every securities issuance, including:
  - Name of holder
  - Number of shares issued
  - Date of issuance
  - Date of Board approval
  - Securities law filings
  - Certificate number
  - Vesting (if any)
- Unlike the cap table, a ledger should show separate entries for each security purchased by an investor – they should not be aggregated by investor

Generating Cap Table

- The cap table is generated by aggregating the data from the ledger
- The cap table generally groups shares by class (e.g., by Common Stock), by class of holder (e.g., founders, investors, etc.) or by each holder separately
- The cap table does not take into account vesting – all shares assumed to be vested
- Cap table generally includes the available, but unissued, portion of the option pool

Pro Forma Cap Table

- A pro forma cap table shows the capitalization of the Company immediately following a financing transaction
- It typically includes the financing itself, the effect of conversion of any convertible notes or SAFEs and any option pool expansion
- The pro forma cap table should be negotiated in parallel with the term sheet, and ideally should be an exhibit or attachment

Why do a Term Sheet?

- Ensures that there actually is a deal – the parties may be hearing what they want to hear, and summarizing the terms in writing provides an opportunity to reflect and confirm that there is a path forward
- For the investor, the term sheet often includes a binding exclusivity portion to enable them to perform due diligence and negotiate the financing documents
- Saves on legal costs – it's much cheaper and more efficient to negotiate and revise a term sheet than the full set of deal documents

Term Sheets are Non-Binding

- A binding term sheet is problematic – the terms aren't sufficiently developed to create a full agreement, creating a question of what the parties intend to be bound to
- A non-binding term sheet may have a limited set of binding terms. Typically these include:
  - Exclusivity
  - Attorneys fees (generally to make it clear that neither party is entitled to them until and unless the deal closes)
  - Governing law
  - Confidentiality of the transaction (confidentiality of any items disclosed in the course of the transaction is typically handled by a separate NDA)

Key Terms – Note Financing

- A valuation is not technically needed as part of a note financing, though a valuation cap is frequently negotiated and therefore results in a valuation being negotiated anyway
- The basic terms of the note, such as principal amount, interest rate and maturity date
- Security interest (a secured note is a much more complicated, particularly with multiple lenders)
- Conversion terms
  - What triggers the automatic conversion
  - What is the discount to the next round
  - Is there a valuation cap?
  - Is there an ability to optionally convert

Key Terms – Equity Financing

- Valuation
- Liquidation preference (participating v. non-participating)
- Dividends (accruing v. when, as and if declared)
- Board seat
- Protective provisions which require Preferred Stockholder consent
- Pre-emptive rights
- Rights of first refusal/co-sale
- Registration rights
- Option pool top up

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"Valuation, Cap Tables, Term Sheets and…Other Things Not to Mess Up"

Vantage Point Advisors

TheSDAngels.com #SDAngelConf

INTRODUCTION

VANTAGE POINT ADVISORS

•Vantage Point Advisors is an independent corporate valuation firm, with offices in San Diego, Los Angeles, Portland, Seattle and New York City.

•We are a leading provider of valuation services for transactions, fundraising efforts, tax reporting and compliance, financial reporting, litigation support, fairness and solvency opinions and other business advisory services.

Our team has collectively completed thousands of engagements enabling us to provide practical and comprehensive valuations. VPA brings significant transactional, operational and financial expertise to each project.

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AGENDA

What I hope to accomplish today:

- Review the dynamics of debt vs. equity financing
- Explain the basics of valuation
- Provide an understanding as to why valuation is important in protecting founder's ownership
- Warn of investor "tricks" to be aware of in debt and equity financings

FINANCING – DEBT VS. EQUITY VS. ALTERNATIVES

Startup companies have a number of ways to finance their operations and growth…

•**Debt Financing** – A Company borrows funds from an investor for a fixed period of time at a set interest rate. The face value of the loan must be repaid over time. This loan to the Company is collateralized by the future operations of the Co. and sometimes its physical assets.

- **Types of Debt –** term loans, lines of credit, private placement debt, SBA loans, convertible notes
- **The 'Players' –** traditional banks (national & regional), venture banks, the SBA, PE (Debt funds)
- **The Main 'Pro' to Startups –** non-dilutive to ownership. The Company is paying interest but *not* giving up ownership percentage these outsiders.
- **The Main 'Con' to Startups –** early stage companies are typically lent money at very high interest rates. Also corporate debt securities take a first lien position. So if the Co. is dissolved or goes through a less than ideal asset sale, the founders could be left with nothing.

FINANCING – DEBT VS. EQUITY VS. ALTERNATIVES (CONT.)

Startup companies have a number of ways to finance their operations and growth…

- **Equity Financing** – An investor buys and holds a piece of the Company in exchange for cash consideration. Because the investor is now an owner they are privy to dividends and capital gains.

  - **Types of Equity –** preferred stock investment, common stock investment, optional securities (warrants, options, etc.)

  - **The 'Players' –** VCs, PEs, family offices, angels, wealthy individuals, friends or family with some extra cash, etc.

  - **The Main 'Pro' to Startups –** no monthly payments to drain cash flow and no interest charges. Risk is passed on to investor/owners.

  - **The Main 'Con' to Startups –** these investors now own a portion of your business. They can now have a say in how you run your Co. As owners, equity investors have claim to Co. profits and exit value (gains).

In summary, when an investor buys a corporate bond, they lend money to the Co. When an investor buys stock, they buy a piece of the ownership pie.

FINANCING – DEBT VS. EQUITY VS. ALTERNATIVES (CONT. - 2)

Other options…

- **Alternative Financing** – over the years innovation and creative thinking has led to numerous 'alternative' ways to finance a start-up

  - **Convertible notes –** a hybrid of debt and equity. These are loans that initially collect interest and are paid monthly until an event or milestone triggers conversion into equity and an ownership position.

  - **SAFEs** (simple agreement for future equity)- Cash investment to get stock at a future date in-line with an equity financing. No immediate ownership claim or interest receivable.

  - **Crowd funding –** funding a Co. by raising money from a large number of people usually via an online forum. Crowdfunding is either Rewards based (Co. product or services) or Equity based (offering a equity stake for cash)

  - **Peer-to-Peer lending –** small business loans offered through an online platform that matches lenders and businesses. Ex. – Kabbage, Prosper, Funding Circle, etc.

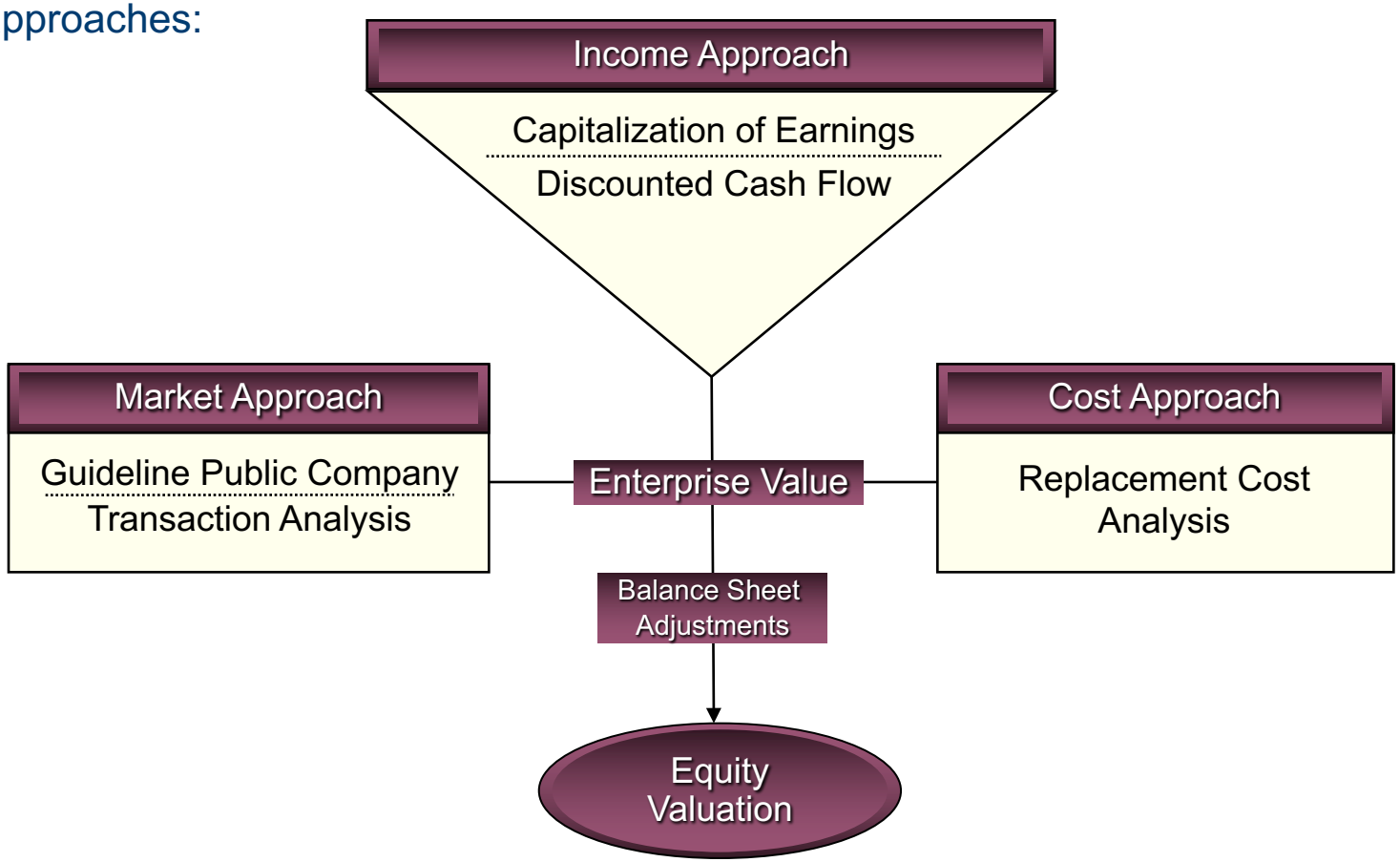
THE BASICS OF VALUATION

No matter how a Company will be financed, valuation will play a role in the terms. So what is this voodoo art form???

- **Simplified - All business valuations hinge upon 3 main factors:**
  1. Growth
  2. Risk
  3. Cash flow generation (margin & earnings)
- **Investors pay for future expected cash flows (earnings).**
  - Underlying assets (systems, products/services, or technologies, etc.) produce that expected cash flow.
- **Most SDAC affiliated companies currently are:**
  - High risk;
  - Low to no margin/earnings;
  - But with hyper growth potential.

BUSINESS VALUE DEVELOPMENT – THE "HOW TO"

- All companies, even start-ups, can be valued using one of 3 main valuation approaches:



PRE-MONEY VALUE DEVELOPMENT – THE "HOW TO"

- Early or development stage companies, like SDAC companies, have a few options. As follows:
- Income Approach – Discounted Cash Flow Method
  - Where the company's future performance discounted at an applicable rate of return indicates its worth today.
    - Should include future efforts of built-out management team and the benefits of the capital raise.
    - Discount rate selection is big. Using a public company cost of capital (single digits or low teens) will over inflate your valuation and make you look unsophisticated to some investors.
    - Using a typical venture-backed rate of return (20%-40%) is appropriate and will make you look like you know what you're doing!
- Market Approach – Guideline Public Company Method or Guideline Transaction Method
  - Pricing pre-money value off of multiples of future, projected metrics.
  - Examples: Pre-money valuation based off 2X 3-year forward revenue forecast or 8x 3-year forward EBITDA forecast.

PRE-MONEY VALUE DEVELOPMENT – THE "HOW TO"

- So, what matters in these Market Approaches?
  - Well thought out forward forecast with regard to market penetration and barriers to entry.
  - Multiples selected from GPC's and transactions are adjusted for risk, growth, and future margin of your business vs. comparables.
- Where do I get the market multiples and/or licensing information?
  - SEC filings for public companies and transaction databases for public and private company mergers and acquisitions.
- Be Prepared – "Why should I buy-in @ a 8x 2019 EBITDA as of today?"

PRE-MONEY VALUE DEVELOPMENT – THE "HOW TO"

- Cost Approach – Replacement Cost Method
  - Method is applicable for tech companies where developed IP is the main asset of the company.
  - Aggregation of the amount spent to date (including sweat equity) multiplied by an expected yield.
- But remember…ultimately, your Co. pre-$ valuation is what the market is willing to bear.
  - A prominent VC once said that funding a company's first round comes down to largely 2 things:

    1) Do I TRUST this founder?

    2) Did this pitch BORE or CONFUSE me?

VALUATION: WHY IT'S IMPORTANT TO STARTUPS

- A Simple Example – Most startups use the basic formula of how much ownership they are willing to initially give up and how much they need to fundraise. As follows:

- Seeking to raise $1 million in Series A

- Current shares outstanding are 100

- I'm only willing to give up 20% ownership

  - Post-Money = $1 million ÷ 20% = $5 million

    - Now 25 Series A shares out of 125 total shares

  - Pre-Money = $5 million post-money less $1 million invested = $4 million

VALUATION: WHY IT'S IMPORTANT TO STARTUPS

- What if a full valuation was performed and the Co. determined its pre-money value was *actually* $7 million??
  - Post-Money = $7M Pre-$ + $1M raised = $8M
  - $1M/$8M = 12.5% ownership given up
    - The owners have managed to keep 7.5% more ownership than at the $4M Pre-$. We've thwarted off unnecessary dilution!
- Valuation equally important for debt financing where lenders focus on solvency metrics.
  - Loan to enterprise value - $1M/$4M = 25%
  - Loan to enterprise value - $1M/$7M = 14%
- Once I have my valuation, what are those investor tricks that I have to be aware of?

INVESTOR "TRICKS" - VENTURE DEBT: TRULY NON-DILUTIVE?

- Venture debt providers coin their financing options as "non-dilutive capital". But is it really? What to be aware of…
  - Venture term loans typically have warrant coverage. This means you are being offered a typical interest bearing loan but also giving the lender essentially "options" to own an equity stake in the future, above a fixed strike price.
  - Convertible notes often seem attractive but discount factors at conversion can overly dilute founder's ownership. *Example to follow*.
  - High yield debt with no equity component can still trigger dilution. How?
    - Above market interest rates mean a higher burn rate and less cash flow retained. This equates to a shorter cash runway and the need to fundraise that next round earlier (triggering earlier than necessary dilution).

RAISING CONVERTIBLE DEBT – WHY THE DISCOUNT MATTERS

- Most “first-in” debt financiers want a discount on their future conversion to equity and that discount matters…
- Assume $1,000,000 convertible promissory note at 8% interest
  - Next qualified financing (“NQF”) / conversion is 2 years from issuance date
  - Interest accrued would be $160,000
  - Principal and interest would be $1,160,000 at NQF
- 10,000,000 shares of common stock are outstanding in addition to the convertible note.
- The next qualified financing issue price is expected to be $1.00.

RAISING CONVERTIBLE DEBT – WHY THE DISCOUNT MATTERS

- Ownership given up with no discount = 10.4%
  - Converts into 1,160,000 shares
    - $1,160,000 / ($1.00 * (1 – 0%)) = 1,160,000
- Ownership given up with conversion at 20% discount = 12.7%
  - Converts into 1,450,000 shares
    - $1,160,000 / ($1.00 * (1 – 20%)) = 1,450,000
- Ownership given up with conversion at 50% discount = 18.8%
  - Converts into 2,320,000 shares
    - $1,160,000 / ($1.00 * (1 – 50%)) = 2,320,000

INVESTOR EQUITY "TRICKS" TO BE AWARE OF

Read the purchase agreement! Don't just sign on the dotted line…

- Participating preferred stock – In an exit, allows preferred stock holders to immediately participate as common holders after receiving their money back. Do not have to wait to convert to common at a fixed price. This features hugely eats away at the value of common stock upon an exit.
- Cumulative dividends – interest rate on equity essentially. If cumulative, gives investors a preferred return over time, no matter the performance of the entity.
- Conversion that is not 1:1 – 1:2 conversion, for example, could give preferred investors double the shares at the point when they convert to common stock.
- > 1x liquidation preference ("LP") – 2x LP on a $5 million preferred investment would give the investor a $10 million payback, before any value accrues to other shareholders.
- Always negotiate "vanilla" preferred stock deals!
  - Non-participating preferred stock
  - No cumulative dividends
  - 1:1 conversion
  - 1x LP

INVESTOR EQUITY "TRICKS" TO BE AWARE OF

Investor tricks in summary…

Financing Feature	Say No!!!
Debt – warrant coverage	X
Debt – deep discount conversion **%'s** on convertible notes	X
Debt – above market interest rates	X
Equity - participation	X
Equity – cumulative dividends	X
Equity - **>**1:1 conversion	X
Equity - **>**1x LP	X

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