Morgan Lewis is proud to present Technology May-rathon, a series of tailored webinars and in-person programs focused on current technology-related issues, trends, and legal developments.

This year is our 9th Annual May-rathon and we are offering over 25 in-person and virtual events on topics of importance to our clients including issues of privacy and cybersecurity, new developments in immigration, employment and tax law, fintech, telecom, disruptive technologies, issues in global tech and more.

A full listing and of our tech May-rathon programs can be found at https://www.morganlewis.com/topics/technology-may-rathon
1. Capital Structure Characteristics
2. Early Stage Debt Financing – Debt vs. Equity
3. Early Stage Debt Financing – Fundamentals
4. Early Stage Debt Financing – Recent Market Trends
5. Early Stage Debt Financing – Term Sheet / Key Considerations
6. Early Stage Debt Financing – Collateral Issues
7. Early Stage Debt Financing – Pricing
8. Early Stage Debt Financing – IPO Implications
CAPITAL STRUCTURE - RANGE OF CHARACTERISTICS

- **Common Stock**
  - **Preferred Stock**
    - Dividend Preference (and share with common)
    - Voting Rights
    - **Preferred Stock**
      - Dividend Preference
      - Voting Rights
      - Redemption Rights
  - **Preferred Stock**
    - Dividend Preference
    - Limited Voting
    - Redemption Rights
  - **Subordinated Debt**
    - Unsecured
    - Covenants
    - Right to Vote
  - **Subordinated Debt**
    - Unsecured
    - Covenants
  - **Subordinated Debt**
    - Secured
    - Covenants
  - **Senior Debt**
    - Unsecured
    - Covenants
  - **Senior Secured Debt**
Capital Structure – “Seniority”

- Senior Secured Debt
- Senior Debt (Unsecured)
- Subordinated Debt
- Preferred Stock
- Common Stock
# Early Stage Debt Financing

## Debt v. Equity

<table>
<thead>
<tr>
<th>Debt Financing</th>
<th>Equity Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debtor/Creditor Relationship</td>
<td>Equity Partner Relationship</td>
</tr>
<tr>
<td>Lower Cost of Capital</td>
<td>Higher Cost of Capital</td>
</tr>
<tr>
<td>Based on Cash Flow</td>
<td>Based on Expected Future Value</td>
</tr>
<tr>
<td>Periodic Interest Payments</td>
<td>“Interest” Accrued, but not Paid</td>
</tr>
<tr>
<td>Fixed Maturity Date</td>
<td>Defined Range of “Exit” Dates</td>
</tr>
<tr>
<td>Financial and other Covenants; Warrants</td>
<td>Less Restrictions</td>
</tr>
<tr>
<td>Retired through Operating Cash Flow</td>
<td>Redeemed through IPO, Recapitalization, or Sale</td>
</tr>
<tr>
<td>Board Observer Rights</td>
<td>Board-level Participation</td>
</tr>
<tr>
<td>Little to No Governance Involvement</td>
<td>Active Governance Involvement, as appropriate</td>
</tr>
</tbody>
</table>
Early Stage Debt Financing
Debt v. Equity (cont.)

Key Types of Debt
- Capital Expenditure/Equipment Financing
- Convertible Debt
- Bank Debt Financing/Accounts Receivable/Borrowing Base Credit
- Venture Debt
Early Stage Debt Financing

Key Considerations:
- Size (Dollar Amount)
- Duration
- Pricing of Loan (Fees and Interest)
- Timing of Amortization
- Covenants

Market Players
- Commercial banks with venture-lending arms
- Specialty Finance Firms
- Hedge Funds
- Venture Capital Funds

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Early Stage Debt Financing

Why Debt?

- Nominal to no dilution of capital
- Leverage equity raised to reduce the average cost of capital
- Extend cash runway

Example:
- Series A round: $5 million at 20% ownership
  - $25 million valuation
- Monthly cash burn of $500,000
  - Series A provides 10 month runway
- Debt loan of $1.5 million
  - Even with warrant at 50 bps, provides additional 3 month runway with 1/40th the dilution

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Early Stage Debt Financing

**Potential Obstacles**
- Lack of track record
- Revenue
- Negative earnings
- Strong competition
- Cash on hand

**Mitigants**
- Founder’s technical/market expertise
- Well-connected angel and venture investors
- Well-defined business plans

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Early Stage Debt Financing

Market Value

Fig. 5: Average Value of Venture Capital Deals, 2016 - 2018

Source: Preqin
Early Stage Debt Financing
Recent Market Trends

Fig. 3: Number of Venture Capital Deals in 2018 by Investment Stage

- Angel/Seed: 35%
- Series A/Round 1: 14%
- Series B/Round 2: 7%
- Series C/Round 3: 4%
- Series D/Round 4 and Later: 1%
- Growth Capital/Expansion: 1%
- PIPE: 1%
- Grant: 0%
- Venture Debt: 14%
- Add-on & Other: 5%

Source: Preqin Venture Capital Report

Venture Debt = 14% of deals in Q4 2018
Early Stage Debt Financing
The Term Sheet – Key Considerations

Closing Date
Due Diligence/documentation
Costs
Break Fee
Availability
  – Entire Loan at Closing v. Tranched Loan v. Delayed Draw

Maturity Date/Repayment Schedule
  – May be interest free for some period to reduce cash needed to service loan
  – Bullet payments

Interest Rate

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Early Stage Debt Financing
The Term Sheet – Key Considerations (cont.)

Closing Fee
Maturity Fee
  – Also known as an “End of Term” Fee; often in exchange for the reduction or absence of warrants

Prepayment Fee
  – Make Whole v. Discounted Make Whole v. Percent of Drawn amount

Warrants
  – Investor has the option to purchase stock in future at fixed price

Financial Covenants
Affirmative and Negative Covenants are common

Reporting

Board Observer Status

Board Seats

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Security and ranking
  – Negative Pledges over IP

Legal Documentation

“Material Adverse Change” Clauses

Defaults and Events of Default
  – Acceleration
  – Waivers and Consents
Collateral Issues

**Scope of collateral security is often negotiated**

- Equity pledges only?
- Personal property only?
- Real estate collateral?
- Intellectual Property only?
- Bank accounts?
Collateral Issues

Exclusion for security interest in contracts that would be breached by grant of security interest

- Effect of UCC Section 9-406, 9-407, 9-408 or 9-409
  - Overrides contractual prohibitions on granting of security interests in certain types of contracts, financial assets and licenses
  - Allows lender to be a secured party in a bankruptcy
  - Does not necessarily allow foreclosure, so if the contracts in question are critical collateral, loan structuring issues may arise

“Intent to use” trademark filings
Collateral Issues

Example exclusion

... notwithstanding anything in this Credit Agreement to the contrary, the term “Collateral” shall not include any (i) “intent-to-use” trademark applications for which a statement of use has not been filed and accepted with the United States Patent and Trademark Office or any intellectual property if the grant of a security interest therein would result in the cancellation or voiding of such intellectual property by the applicable Governmental Authority, or (ii) any agreement (including agreements relating to intellectual property) to which any Credit Party is a party, only to the extent and for so long as the terms of such agreement or any requirement of Applicable Law (x) validly prohibit the creation by such Credit Party of a security interest in such agreement in favor of the Administrative Agent (after giving effect to Sections 9-406(d), 9-407(a), 9-408(a) or 9-409 of the UCC (or any successor provision or provisions) or any other Applicable Law (including the Bankruptcy Code) or principles of equity) or (y) would result in a termination pursuant to the terms of any such agreement (other than to the extent that any such term would be rendered ineffective pursuant to Section 9-406, 9-407, 9-408 or 9-409 of the UCC (or any successor provision or provisions) of any relevant jurisdiction or any other Applicable Law (including the Bankruptcy Code) or principles of equity), in each case unless and until any required consents are obtained; provided further that Collateral shall include, and the security interest granted in the Collateral shall attach to, any proceeds, substitutions or replacements of any such excluded items referred to herein unless such proceeds, substitutions or replacements would constitute excluded items hereunder.
# Early Stage Debt Financing Pricing

<table>
<thead>
<tr>
<th>Market Terms - Traditional Venture Loan Types</th>
<th>Working Capital Facilities</th>
<th>Sr. or 2L Growth Capital Loans</th>
<th>Mezz./Sub. Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Typical Participants</strong></td>
<td>Banks, non-bank growth</td>
<td>Banks, non-bank growth lenders, select hedge funds</td>
<td>Non-bank specialty lenders, select hedge funds</td>
</tr>
<tr>
<td><strong>Availability</strong></td>
<td>Up to 85% of A/R</td>
<td>Situation specific</td>
<td>Situation specific</td>
</tr>
<tr>
<td></td>
<td>Up to 50% of inventory</td>
<td>% of enterprise value</td>
<td>Up to 5x forward EBITDA</td>
</tr>
<tr>
<td></td>
<td>Up to 100% of select PO's</td>
<td>Up to 50% of equity round</td>
<td>% of enterprise value</td>
</tr>
<tr>
<td></td>
<td>3-6x MRR</td>
<td>6-18x MRR</td>
<td></td>
</tr>
<tr>
<td><strong>Interest Rate</strong></td>
<td>4-7% floating</td>
<td>6-13% fixed or floating</td>
<td>9-15% fixed</td>
</tr>
<tr>
<td><strong>Term</strong></td>
<td>1-3 years</td>
<td>2-5 years</td>
<td>3-5 years</td>
</tr>
<tr>
<td><strong>I/O Period</strong></td>
<td>n/a</td>
<td>6-60 months</td>
<td>3+ years</td>
</tr>
<tr>
<td><strong>Back-end Payment</strong></td>
<td>Typically none</td>
<td>0-10%</td>
<td>0-15%</td>
</tr>
<tr>
<td><strong>Warrant Coverage</strong></td>
<td>Typically none</td>
<td>0-15%</td>
<td>0-20%</td>
</tr>
<tr>
<td><strong>Collateral</strong></td>
<td>1st lien on assets; negative pledge on IP</td>
<td>1st or 2nd lien on assets; negative/double-negative pledge on IP</td>
<td>2nd lien on assets or unsecured</td>
</tr>
<tr>
<td><strong>Commitment Fee</strong></td>
<td>Up to 1%</td>
<td>Up to 2%</td>
<td>Up to 2%</td>
</tr>
<tr>
<td><strong>Prepayment Fee</strong></td>
<td>0-2%</td>
<td>0-5%</td>
<td>3-5%</td>
</tr>
<tr>
<td><strong>MAC Clause</strong></td>
<td>Typically required by banks, typically not by other lenders</td>
<td>Typically required by banks, typically not by other lenders</td>
<td>Typically not</td>
</tr>
<tr>
<td><strong>Liquidity/Financial Covenants</strong></td>
<td>Liquidity / asset coverage</td>
<td>Equity raise</td>
<td>Debt service</td>
</tr>
<tr>
<td></td>
<td>Sometimes NONE</td>
<td>Minimum liquidity</td>
<td>Minimum EBITDA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Performance to plan</td>
<td>Performance to plan</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Sometimes NONE</td>
<td>Sometimes NONE</td>
</tr>
<tr>
<td><strong>All-in Cost</strong></td>
<td>5-9%</td>
<td>9-20%</td>
<td>15-25%</td>
</tr>
</tbody>
</table>

Source: Spinta Capital
Early Stage Debt Financing
IPO Implications

- IPO Activity is strong in 2019 and is anticipated to continue to be strong for the balance of this year. IPO’s were roughly 54% of the value of all exits in Q1 2019.
- Longer deals, including deals with debt capital in place, support a longer cash runway.
- Debt deals postpone valuation negotiations (avoid down rounds and flat rounds).
- Bank debt working capital facilities evidence positive signals to the market.
- Avoid or slow dilution.

Source: PitchBook – NVCA Venture Monitor
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Questions? Please email **Jessica Feldman** at **jessica.feldman@morganlewis.com**

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Thank you for running in the 2019 Technology May-rathon with us.

We would be pleased to answer your questions.

The Q&A tab is located on the bottom right hand side of your screen. Please type your questions in the space provided and click Send. If we cannot address your question during the live program, someone will reach out to you directly via email with an answer.
Matthew Edward Schernecke advises direct lenders, mezzanine investment funds, and venture capital investors on loans and other investment transactions with a wide range of borrowers across industry classes and of all sizes, types, and structures. Matthew also advises private equity clients and corporate borrowers on domestic and cross-border acquisition financings, out-of-court restructurings and workouts, bankruptcy matters, and real estate financings. Matthew leads transactions spanning diverse industries, including media and telecommunications, Internet and technology, food and beverage, real estate, retail, and healthcare. Matthew serves as the New York office local practice group leader for the finance group.
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