

Morgan Lewis

Building a Start-Up: Critical Steps for Success

A Carnegie Mellon University &
Morgan Lewis Collaboration

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Coming to Terms:
Negotiating Early Stage Deals



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Overview

- Current market trends
- What is an angel investor?
- Basic terms in an angel round

Current Trends in Venture Capital

- Pace of venture financing still improving
- Valuations still low
- VCs continue to raise the bar

Current Trends in Venture Capital (cont'd)

- There is plenty of money available . . . but some was taken off the table
- Result: decrease in the number of funds . . . but increase in the quality of funds
- Percent of money going into early stage investments (seed/1st round) stabilized after huge decline; VCs still prefer later rounds

Considering Angel Investment – Why Angels?

- Fills the “gap”
 - Finalize “research” or “beta product”
 - Build out management team
 - Find early customers
- Friendly terms
 - Less negotiation (valuation, founder’s share)
 - Less “control” requirements

Who are Angels?

- Old-line business owner looking to learn something new and mentor
- Successful new economy entrepreneur (or employee) that doesn't want day-to-day involvement
- Risk taker looking for high risk/high return investments

Key Decision Making Criteria For Angels

- Credibility of the entrepreneur
 - Personal integrity
 - Willingness to seek advice
- Familiarity with industry or desire to be involved with industry
- Attractiveness of deal – afraid to be shut out later on

**SUMMARY OF TERMS OF
COMMON STOCK/PREFERRED STOCK INVESTMENT**

Set forth below is a summary of the material terms of an investment in XYZ Corp. (the "Company"). In this offering shares of the Common Stock/Preferred Stock are being offered by the Company to investors ("Angel Investors").

Type of Security: Common Stock or Preferred Stock (circle one)

Total Capital to be Raised (before expenses): \$ _____ million

Pre-Money Valuation: \$ _____

| Post-Financing Ownership: | <u>Shares</u> | <u>% Ownership</u> |
|---|-------------------------|-----------------------|
| Founder: | _____ | _____ % |
| Reserved for Option Pool: | _____ | _____ % |
| New Angel Investors | _____ | _____ % |
| <small>(% = Total Capital to be Raised + Pre-Money Valuation)</small> | | |
| TOTAL | <u>1,000,000</u> | <u>100.00%</u> |

Material Provisions of the Common Stock/Preferred Stock:

(1) Dividend Provisions. No dividends shall currently be paid.

(2) Voting Rights. All shares shall vote as one class, except as otherwise required by law.

Information Rights: Stockholders will receive annual financial statements and a semi-annual update letter.

Use of Proceeds: Obtain BSU license, recruit management team, file patents, further clinical research.

Other: Purchasers will sign a Stock Purchase Agreement (which incorporates the terms of this Term Sheet) and an Accredited Investor Questionnaire.

Common Stock or Preferred Stock?

SUMMARY OF TERMS COMMON STOCK/PREFERRED STOCK INVESTMENT

| | |
|-------------------|---------------------------------|
| Type of Security: | Common Stock or Preferred Stock |
|-------------------|---------------------------------|

- Common
 - Generally, no “bells and whistles”
 - Can provide basic contractual rights
 - Information, participation, but no blocking
- Preferred
 - Can provide many protections, but these are often illusory
 - Greater say in future financings, basic operations

Amount of Capital Raise

SUMMARY OF TERMS OF COMMON STOCK/PREFERRED STOCK INVESTMENT

Type of Security: \$_____ million
(before expenses):

- What do you know you need to do?
 - License technology/file patents
 - Attract first management team
 - Get first customers
- What cushion do you need?
 - Pay salaries for 6-12 months
 - Have leverage in negotiation with funder
 - Have credibility with early customers

Valuation

SUMMARY OF TERMS OF COMMON STOCK/PREFERRED STOCK INVESTMENT

Pre-Money Valuation: \$_____

- Very difficult at early stage
 - Few true metrics
 - Often shoot too high
- Run preliminary DCF, using reasonable projections, fair discount rate
- Can look at comparables, outside sources
 - EDGAR
 - Venture Source
 - Ask other entrepreneurs

Founder's Share

SUMMARY OF TERMS OF COMMON STOCK/PREFERRED STOCK INVESTMENT

| Post-Financing Ownership | <u>Shares</u> | <u>% Ownership</u> |
|--|------------------|--------------------|
| Founder: | _____ | _____ % |
| Reserved for Option Pool: | _____ | _____ % |
| New Angel Investors (& = Total capital to be Raised + Pre-Money Valuation) | _____ | _____ % |
| TOTAL | <u>1,000,000</u> | <u>100.00%</u> |

- Value in invention creation, balanced by where company is in the process
- Dilution can be dramatic in future venture round, regardless of angel round “protections”

Option Pool

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| Post-Financing Ownership | <u>Shares</u> | <u>% Ownership</u> |
|--|------------------|--------------------|
| Founder: | _____ | _____% |
| Reserved for Option Pool: | _____ | _____% |
| New Angel Investors (& = Total capital to be Raised + Pre-Money Valuation) | _____ | _____% |
| TOTAL | <u>1,000,000</u> | <u>100.00%</u> |

- 15-20% probably customary
- Avoid front loading too much vesting

A Note on Notes

- For angel rounds or in-between rounds, mandatory convertible notes can work very well
- Protect early investors, don't dissuade institutional funders
- Not discussed in-depth here, but used frequently

Summary

- VCs have returned, but remain wary
- Angels take cue from VCs – but invest for different reasons
- Keep angel terms as simple as possible; close quickly