

Venture Capital Contracts: Part II



Key Terms of VC Contracts

- Anti-Dilution Provisions
- Covenants/ Control Terms
 - Voting Rights/Board representation
 - Protective Provisions
 - Registration Rights
- Employee Terms
 - Vesting periods/Stock Restrictions
 - Non-Competes



Anti-Dilution Provisions

- If the firm raises additional funding at a price *below* the prior round VC's price, the VC's conversion price is lowered to protect against dilution.
- Anti- Dilution protection comes out of founders shares or earlier round investor, if these are not protected against dilution
 - Prevents company from strategically raising later rounds to expropriate investors (avoid “wash out” financing)
 - Helps to maintain constant fraction of equity -- control rights
 - Company and founders bear most of the risk
 - Incentive for founders to create value
 - Golden rule: “Those that have the gold make the rules.”



Anti-Dilution Provisions (cont.)

- **Full Ratchet Anti-dilution:** The conversion price is lowered to the price of the new financing
- **Weighted Average Anti-dilution:** The new conversion price takes into account the number of new shares issued
 - New conversion price = $[(A+C)/(A+D)] * \text{old conversion price}$
 - A: # of common shares outstanding before transaction
 - C: # of shares to be issued if old conversion price had held
 - D: # of shares that are actually issued under new conversion price
 - New shares to initial investors = $(\text{old price/new price}) * \text{initial shares owned}$
 - The more shares are issued (D) at a dilutive price the more the weighted ratchet bites

Anti-Dilution Provisions: Example

Example:

- Company has 2 M shares outstanding
 - 1M common stock to founders
 - 1M convertible preferred to investors, conversion price \$1
- New issue of 50,000 shares at \$0.50, raise \$25,000

Full ratchet:

- New conversion price: **\$0.50**
- Convertible preferred holders get 2M shares or **65.6%** of equity

Weighted average ratchet:

- New conversion price = $(2M + 25,000)/(2M + 50,000) * \$1 = \mathbf{0.988}$
- Preferred stock holders get 1,012,146 shares or **49.08%** of equity



Anti-Dilution Provisions (cont.)

Pay to Play Provision

- Preferred holders lose anti-dilution provision if they do not participate in the next round financing at lower price
 - Best approach is to require each initial investor to purchase a percentage of the new financing round equal to his pro rata ownership among the investor group. The balance of the financing will be allocated to new investors.
 - **In current environment:** Preferred automatically converts to common if investors do not participate in dilutive financing

Participation Rights

- **First Refusal Rights**

- Rights to purchase shares proposed to be sold by any shareholders

- **Preemptive Rights**

- Gives investors the right to buy new shares offered by the firm in later financing rounds

- Rights end at time of IPO

- **In current environment:** Right to invest 2x pro-rata ownership in later round

Control Rights

- Entrepreneurs want to have control over the development of the business
 - Control is most important when the company is growing
- VC wants to insure high returns on the investments
 - Control is most important when things are not going well
- The goal is to structure contracts as to allocate control to the party that has more benefits and expertise in using it
 - Voting Rights/Board Representation
 - Protective Provisions

Control Terms

- **Voting Rights**

- Preferred votes number of shares as if converted into common
- VCs control votes in 57% of deals, whereas entrepreneurs control votes in 23% of deals. Neither has control in 20% of the deals.
- If performance and vesting targets are not met, VC increases control in 72% of the cases

- **Board Representation**

- Average size of board is 5
- VCs get 41.5% of seats on average; entrepreneurs get 34.7% on average; outsiders the remainder.



Control Terms

- **Protective Provisions (Class Voting Rights)**

- Approval of preferred holders is required for

- Sale, merger, or liquidation of company

- Changes in corporate charters

- Major acquisitions or budget changes

- Appointment or termination of CEO etc.

- Allows investors to prevent any actions by management that materially change the business risk of the company

Mile Stones

- **Performance Contingencies:** Historically in about 44% of deals, some aspect of the contract is contingent on financial or non-financial performance measures
 - Voting control to VC if EBIT below some threshold
 - Share vesting contingent on FDA approval
 - “Earn-ins”: Earn equity by meeting value goals
 - Additional funding conditional on completing a new benchmark
- **In current environment:** Majority of closings includes milestone based tranches

Exit Provisions

- **Tag-Along**
 - If an offer is made for a shareholder's shares, that offer must be extended to other shareholders (VC)
- **Drag-Along**
 - Right to force all shareholders to sell company upon board and majority shareholder approval
- **Co-Sale Right**
 - Allows VC to exit at the same rate and time as a founding shareholder



Registration Rights

- Stipulate the extent to which preferred versus common stock will share equal/preferential treatment when the stocks have been converted and participate in an IPO
- **Demand Rights:** Allow investors to demand that the company goes public even if management does not want to
- **“Piggy-back” Rights:** Allow investor to include his shares along side with company in an IPO
- **Lock-up Provision:** Specifies the period until shares vest
→ Often determined by the underwriter



Goal of Employee Terms

- Compensate employees for taking risk and hard work
- Provide incentives to encourage superior performance
- Retain talent in the company



Employee Terms

- **Reserved shares**

- Pool of shares that can be given to employees for incentives/compensation reasons
- Typically represents 10%-15% of total fully diluted capitalization
- Usually require board approval
- Shares issued in excess of the allotted pool trigger anti-dilution provisions

- **Non-competes**

- Investors want ensure that key employees do not leave to form competitive firm
- Time period of non-compete: 1-2 years



Stock Restriction Agreements

- **Vesting of founders' shares**
 - “Golden hand-cuffs”: Prevents sale of stock before a certain date
 - Four years on the East Coast, three years on the West Coast
 - Vesting normally occurs quarterly
 - **In current environment:** Moving to five year vesting
- Right to buy back unvested shares of entrepreneur at original purchase price, if he leaves the company
- Accelerated vesting for certain (top) managers in acquisition
 - Avoid hold-up problems



Important Aspects of VC Deals

- Staging of Capital Commitments
- Type of Venture-Capital Firm



Staged Capital Commitment (SCC)

- VCs fund companies in multiple “rounds”:
 - Seed stage
 - Start-up
 - Early stage
 - Expansion
- In the 1982-1990 period, the time between rounds was typically a year, with more dollars being committed in the later rounds.
- The rounds tend to be shorter in high-tech industries and for smaller sums.

The Dual Roles of SCC

- Control Mechanism
 - Entrepreneur has to come back to VC for funding at several points. Allows investor to monitor the firm and to shut it down (i.e. not fund it) if the success probabilities are poor.
 - Option to abandon!
- Signaling and Screening
 - Entrepreneurs who are confident about their prospects will want to defer raising capital until the firm has passed some milestones.
 - SCC allows the entrepreneur to issue equity at a more favorable price and enables VCs to screen among entrepreneurs.

Example: SCC as a Control Mechanism

- Mit.com needs:
 - \$10M to get things off the ground
 - \$20M a year from now for further development of the business.
- Next year, news about firm's prospects will have come out:
 - Good news (2/3 prob.): Certain success => \$150M payoffs
 - Bad news (1/3 prob.): 1/10 chance of success (\$150M payoff) and a 9/10 chance of failure (\$0 payoff).
- If bad news comes out, efficient not to invest \$20M to get expected payoff of \$15M.

Example: Financing without SCC

- Suppose company raises \$30M all at once, up front.
- The entrepreneur will always choose to invest at both stages if his next best job is not very good (even when it is economically inefficient) and he'd have to return the \$20M if he didn't invest.
- In exchange for \$30M, VC will demand **28.5%** of the equity, as $28.5\% * (2/3 * 150 + 1/3 * .1 * 150) = 30$
- Entrepreneur is left with **71.5%** of the company.



Example: Financing with SCC

- **Assume:**
 - Entrepreneur raises \$10M now, extra \$20M if good news realizes.
 - If bad news comes out, he does not raise money.
- **Solve backwards:**
 - If good news comes out, sell 13.3% of firm to raise \$20M (= $13.3\% * 150$)
 - In start-up stage, company is worth $2/3 * 150 = 100$, sell 10% of the company to raise \$10M.
- The entrepreneur sells only **23.3%** of company.

Note: The initial round investor has to own more than 10% of the company initially in anticipation of getting “diluted” in the subsequent round. For example, if initially there are 1000 shares owned by E, first round investor buys 130 shares (owning 13.4% of company) and second round investor buys 173.9 shares.



Type of Venture-Capital Firm

- VCs differ in many ways --- capital under management, age, portion of fund invested, and industry expertise.
- These differences affect the way VCs manage their investments.
- For example, VCs with considerable industry expertise can more effectively guide portfolio firms, bring in industry experts, or use their industry contacts to help portfolio firms (thus, the Kleiner-Perkins *keirestu*).

An Important Caveat about VC Firms

- VC firms are intermediaries, i.e., they are *agents* of the venture fund's limited partners.
- To finance the next fund, VCs have to prove they've made money on the current fund by selling portfolio firms or taking them public, i.e., reach a liquidity event.
- This creates incentives to sell or take a company public too early
 - Fund have an incentive to “grandstand”.
 - Particularly for young and small VC firms.

Evidence of Grandstanding

- On average, first-fund VC firms take firms public after 2.7 years versus 4.5 years for later-fund VC firms.
- First-fund VCs set up next fund 1 year after first IPO in first fund; later-fund VC firms set up next fund in 2.4 years.
- IPOs of first-fund VC firms are greater than IPOs of later-fund VC firms (18.5% versus 7.8%).
- Age of VC firm matters!

Source: Paul Gompers, "Grandstanding in the Venture Capital Industry," *Journal of Financial Economics*, Sept. 1996.



VCs Bring Assets and Liabilities

Assets:

Cash

Industry Contacts

Managerial Expertise

Liabilities:

Need to reach liquidity event

Conflicts among the syndicate

Different objectives

