15.391 Early Stage Capital F10

SAMPLE STRATEGIC INTERNAL AGENDA

Note: *This agenda is abridged from an excellent agenda prepared by ESC students in Fall 05. Please review the syllabus for the general requirements for the agenda. This agenda demonstrated an excellent understanding of the legal and business issues at stake, but also did a very thorough job setting out the actual language of various pitches and rejoinders, in anticipation of VC negotiating tactics.*
Their written preparation paid off in the best-negotiated round (and highest grade) in the course.
This sample is for illustration purposes only. ***DO NOT*** *fill in the sentences provided here. Your grade will suffer mightily if you do. Use this agenda as a starting point to think through your own preparation for your VC round.*

Participants: XXX Venture Partners
A+ Student Team.

Issues to be Discussed:

Introductory Remarks (5 min) – by CEO

I. – Antidilution (15 min) –

As written (p. 2):

The terms of the Series A Preferred Stock will contain full ratchet anti-dilution protection with respect to the issuance by the Company of equity securities at a price per share less than the applicable conversion price then in effect, subject to standard and customary exceptions. The conversion rate of the Series A Preferred Stock into common stock will be adjusted appropriately to account for any stock splits, recapitalizations, mergers, combinations and asset sales, stock dividends and similar events (the "Series A Conversion Price").

What we want: We want to remove full ratchet anti-dilution protection and use weighted average anti-dilution instead.

What is acceptable: We will accept weighted average anti-dilution protection. We are willing to discuss up to 6 months full ratchet. Ideally we will not have full ratchet. It is a **deal breaker**.

Their Rationale:

The VC is trying to get the best preferred stock conversion ratio if our future financing rounds issue at a lower price. Their rationale is to:

1. Protect themselves if the current valuation of the company is too high
2. Hedge the VC's downside risk if the company will experience operational or financial difficulties that result in a lower valuation
3. Hedge macroeconomic risks that can adversely affect our firm

Our Rationale:

We understand our VC's perspective. However, we are confident in our current valuation. We believe that full ratchet protection is not a market behavior. According to a research by Hale and Dorr shows that 97% of the deal in 2004 used weighted average. We want to be a partner of our VC. We expect our VC to accept the risk and share our success. We feel that full ratchet protection will derail the partnership agreement because VC may act as a bank since they have minimized downside risk.

Our Strategy to Negotiate could focus on:

1. I think we understand your perspective. But full-ratchet is not common market practice. According to a research by Hale and Dorr 97% of the deals in 2004 used weighted average. Why do you think that we would fall into the 3% anomaly? Since we have agreed on a valuation, are there other issues we should be discussing?

2. We would all like to share the success if the company takes off. We want to be a partner of our VC. We hope our VC will take on the risks that we are. This is very important to us. We can certainly benefit from your experience. But more importantly, we would like our VC to be as dedicated as we are during both the ups and downs of the market. We believe that weighted average anti dilution is best way to ensure that.

3. Full ratchet is not very different from borrowing from a bank and putting down our houses as collateral. The bank has little downside risk. It is more of loan agreement than a partnership agreement.

<u>II. –Participating Preferred</u> (10 min) –

As written (p. 2):

The holders of Series A Preferred Stock shall have preference upon liquidation over all holders of Common Stock and over the holders of any other class or series of stock that is junior to the Series A Preferred Stock for an amount equal to the amount paid for such Series A Preferred Stock plus any declared or accrued but unpaid dividends. Subsequent proceeds shall be distributed pro rata among the holders of Series A Preferred Stock and the holders of Common Stock.

What we want:

What is acceptable:

Their Rationale: The VCs attempt to minimize their downside by using a liquidation preference to ensure . . . This typically means that if . . .

Our Rationale:
1. We have worked for a long time to create the company. . .
2. Our risk is non diversifiable . . . We would like the VC to share . . ..
3. Participating preferred gives the VC incentive . . . .

Our Strategy to Negotiate could focus on:

1. (To be used if investor mentions that we have to cover our downside) . . .
2. (To be used if Investor argues risk/return paradigm) . . .
3. . . .
4. . . .
5. Hale and Dorr's research shows . . .

I I I. – Option Pool (10 min) –

X% vs. Y% (important)

As written (p. 2):

Capital Structure Following Series A Round:	Existing holders of Common Stock	40%
	Option Pool	20%
	Holders of Series A Preferred Stock	40%
	Total	100%

What we want:
What is acceptable:
VC's Rationale: The founders are often . . .

Our Rationale: As founders, we have worked very hard . . .

See *Appendix A* for our hiring schedule.

IV. – Vesting (10 min) – Rajat

Vesting schedule (deal breaker)

As written (p. 2):
All stock and options held by founders, management and employees shall vest over a four-year period, with equal quarterly installments over four years with a one year cliff at the beginning of the vesting term. Change of control provisions to provide for no more than an additional 25%.

What we want:
What is acceptable:
Their Rationale:
Our Rationale:

<u>V. – Additional Issues to be discussed</u> (10 min) –

1. Voting rights

The voting rights term gives significant rights to the holders of Series A Preferred stock to vote on several issues that we feel should be board matters rather than for stockholder consideration. We would like . . .

2. Standstill

3. Loan

XX, our CFO, has extended a $400,000 loan to the company. Since this amount is substantial, he would like to . . .

4. Registration rights

We have been advised by our lawyers . . .

5. Right of first refusal

6. Redemption schedule

7. Conversion

8. Board of directors:

9. Expenses (VC Legal Expenses)

Appendix A

Five Years Staffing Plan

Table 1shows our staffing plan for the next five years operation.

Table 1 Five Year Staffing Plan

Position	Option (percentile)	Quantity				
		Year 1	Year 2	Year 3	Year 4	Year 5
Founder & Senior Management						
Founder Total	25%					
Senior Management Total	9%					
Sales and Marketing						
Sales & Marketing Total	1%					
R&D						

R&D Total	9%					
Others						
Others Total		:		E:	E:	E:
Total	17%					