

# Venture Capital Deal Terms



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# Venture Capital Deal Terms

Deal Terms Are A Function Of Many Factors Including:

- Type of Investor
- The Size Of The Investor's Checkbook
- The Economics Of The Investment Opportunity
- The Funding Cycle

# Deal Terms Are A Function Of Many Factors Including:

## – Type of Investor

- » “Principal” Investors - Institutional or Individual Investors
- » Fund Investors
- » Corporate Strategic Investors

## – Not All Money Is EQUAL:

- Money Comes With Different Benefits and “Strings” Including Legal Requirements:
  - Which Apply To Where the Money Comes From- The Ultimate Source Of The Funds
  - Which Derive From The Legal Structure of the Investing Entity

## Deal Terms Are A Function Of Many Factors Including:

- Type of Investor
- **The Size of Investor's Checkbook**
  - Determines the Size of Investment Needed
  - Determines the Appetite and Ability To Do Follow-on Rounds
  - Results in Deal Terms Which Protect Initial Investment or Position for Future Investment

## Deal Terms Are A Function Of Many Factors Including:

- Type of Investor
- The Size of Investor's Checkbook
- **The Economics Of The Investment Opportunity**
  - Valuation and Attractiveness of the Opportunity
  - Business Plan Requirements
    - Financial Resources Required
    - Staging of Financing Requirements
    - Completeness of Team - Additional Equity Pool Needs

## Deal Terms Are A Function Of Many Factors Including:

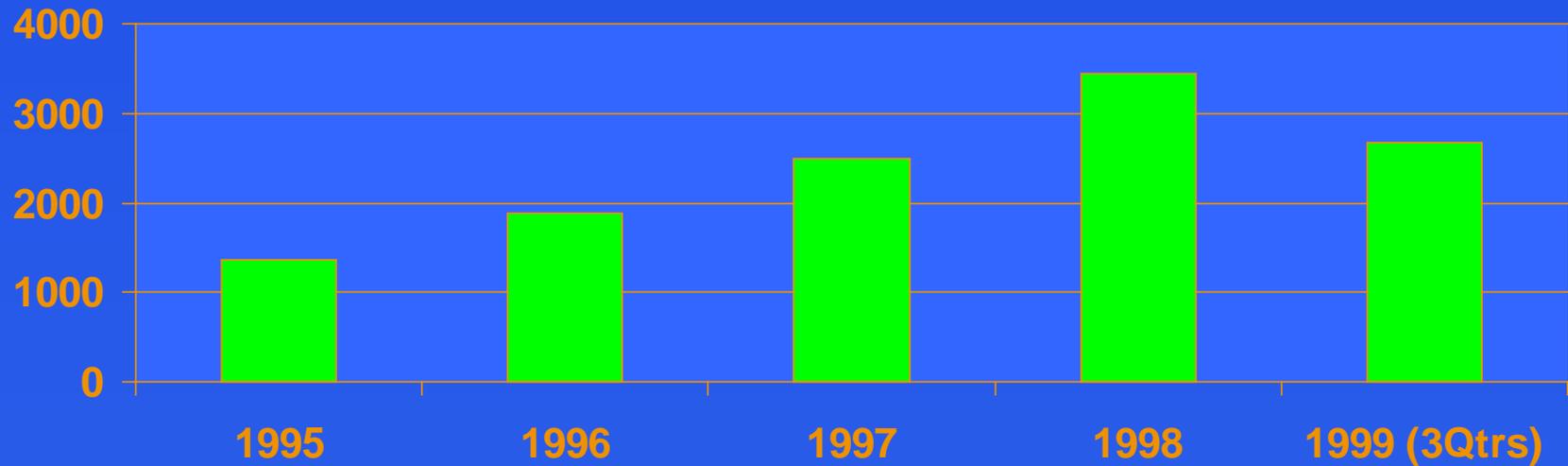
- Type of Investor
- The Size of Investor's Checkbook
- The Economics Of The Investment Opportunity
- **The Funding Cycle**
  - For the Company
    - Seed Stage    – First or Second Rounds    – Mezzanine Rounds
  - For the Investor and Its Sources of Funds
    - Conditions and Trends in the Financial Markets
      - » Venture Capital Fund Raising Has A Cycle Too

# Venture Capital Funding Cycle

- Deal Terms Are Influenced By How Much Venture Capital Is Available
  - » By Stage of Investment
  - » By Industry Sector
- Capital Availability Affects
  - » Deal Pricing
  - » Deal Term Flexibility Where Flexibility Is Possible

# The State of Venture Capital

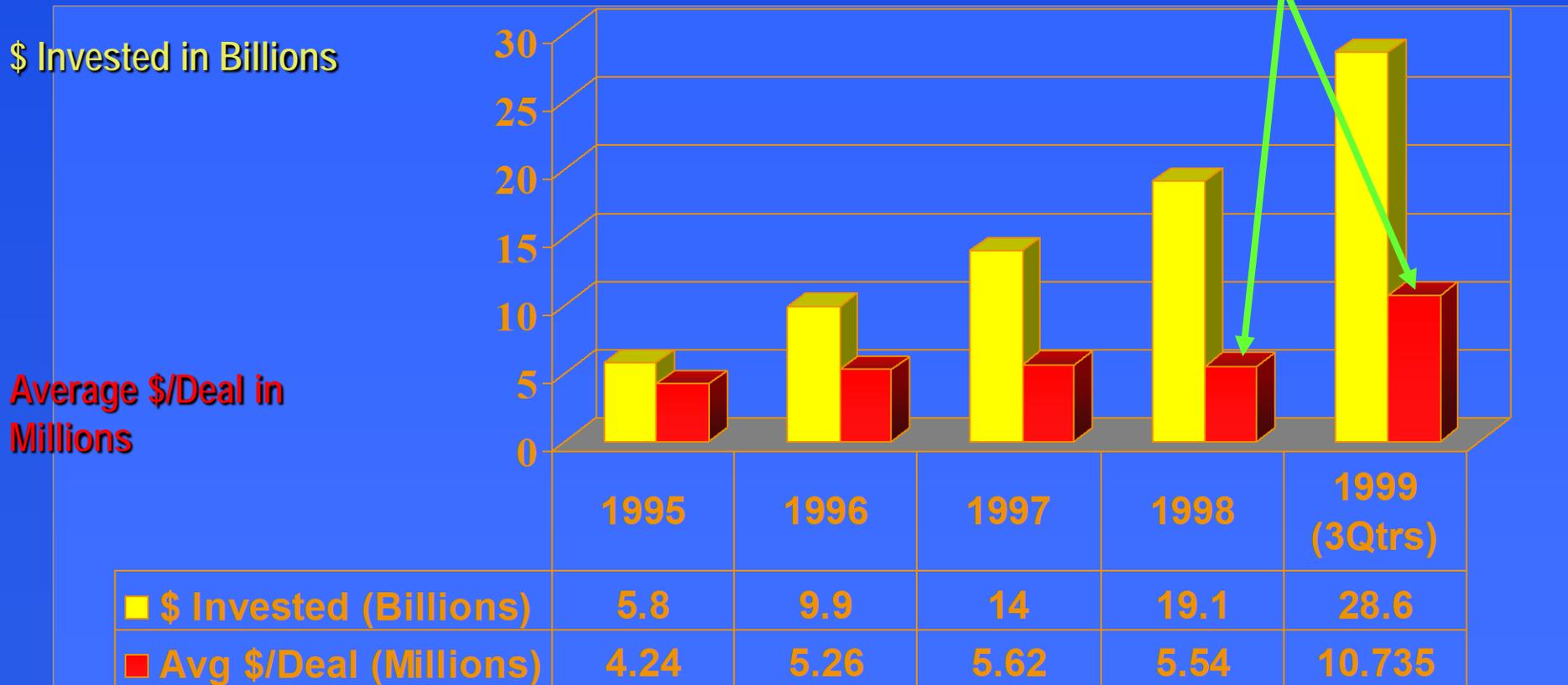
## The Number of Venture Capital Deals Is Increasing



Source: Venture Economics

# The State of Venture Capital

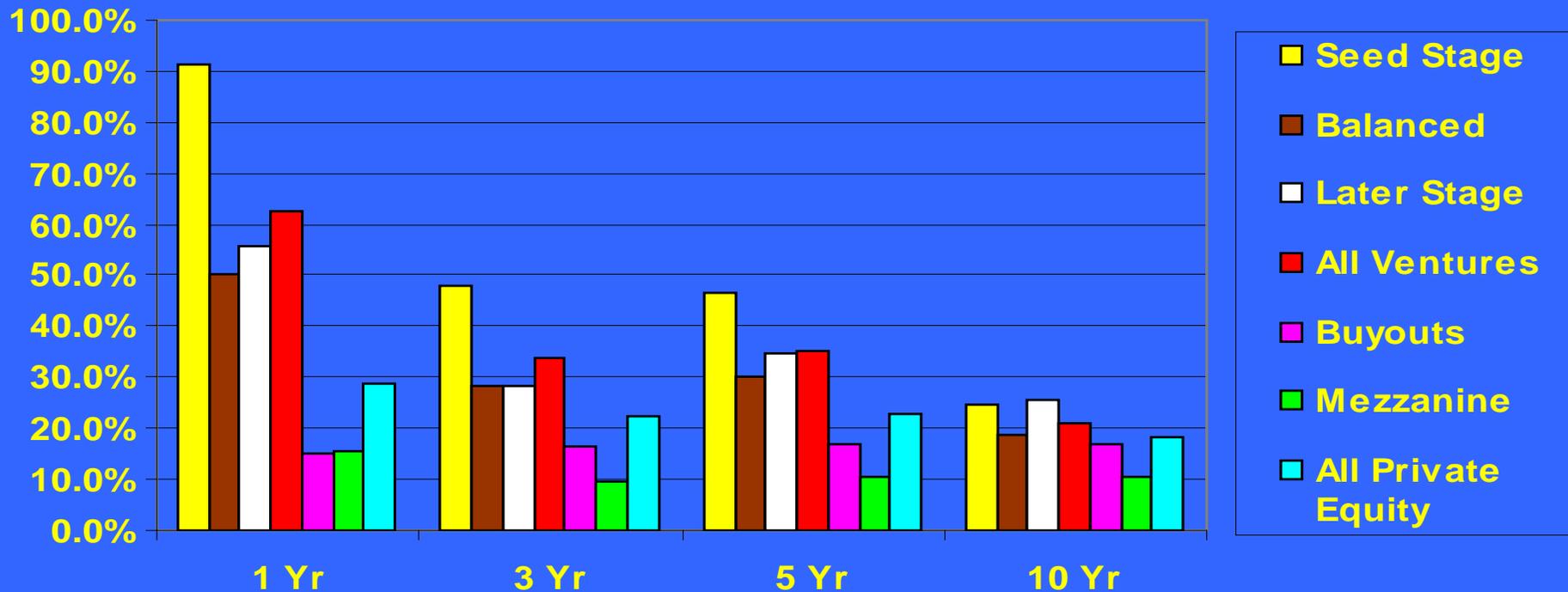
## The Average Deal Size Doubled In 1999



Source: Venture Economics

# Venture Capital Investment Returns

## Seed Stage Returns Are Up Substantially



Source: Venture Economics Jan 2000

# Venture Capital Funding Cycle

## □ SUMMARY

- Today There Is More Competition For Deals
- This Is Reflected In:
  - Valuation of Deals
  - More Flexibility in Terms Where Flexibility Is Possible

# So, What Are The Deal Terms?

## VENTURE CAPITAL LP REVISED TERM SHEET

PCI, Inc.  
66 Sutton Business Park  
The Twilight Zone

**Issue:** Venture Capital LP ("VC") and/or any member of its corporate group ("the VC Group") will purchase up to \$2,500,000 Series A Convertible Preferred Stock ("Series A") newly issued by PCI, Inc. (the "Company") at a price per share of \$1.00 (the "Purchase Price"). In addition, other investors shall purchase at least \$4,500,000 but not more than \$7,000,000 of newly issued Series A at the Purchase Price.

The shares of Series A will be convertible at any time at the option of the holder into common shares of the Company ("Common Stock") on a one-for-one basis, adjusted for future share splits.

# Major Deal Elements

- A Preferred Return
- Protection of Valuation and Position re: Future Money
- Management of the Investment
- Exit Strategies

# A Preferred Return

## □ Perception of the VC Investor:

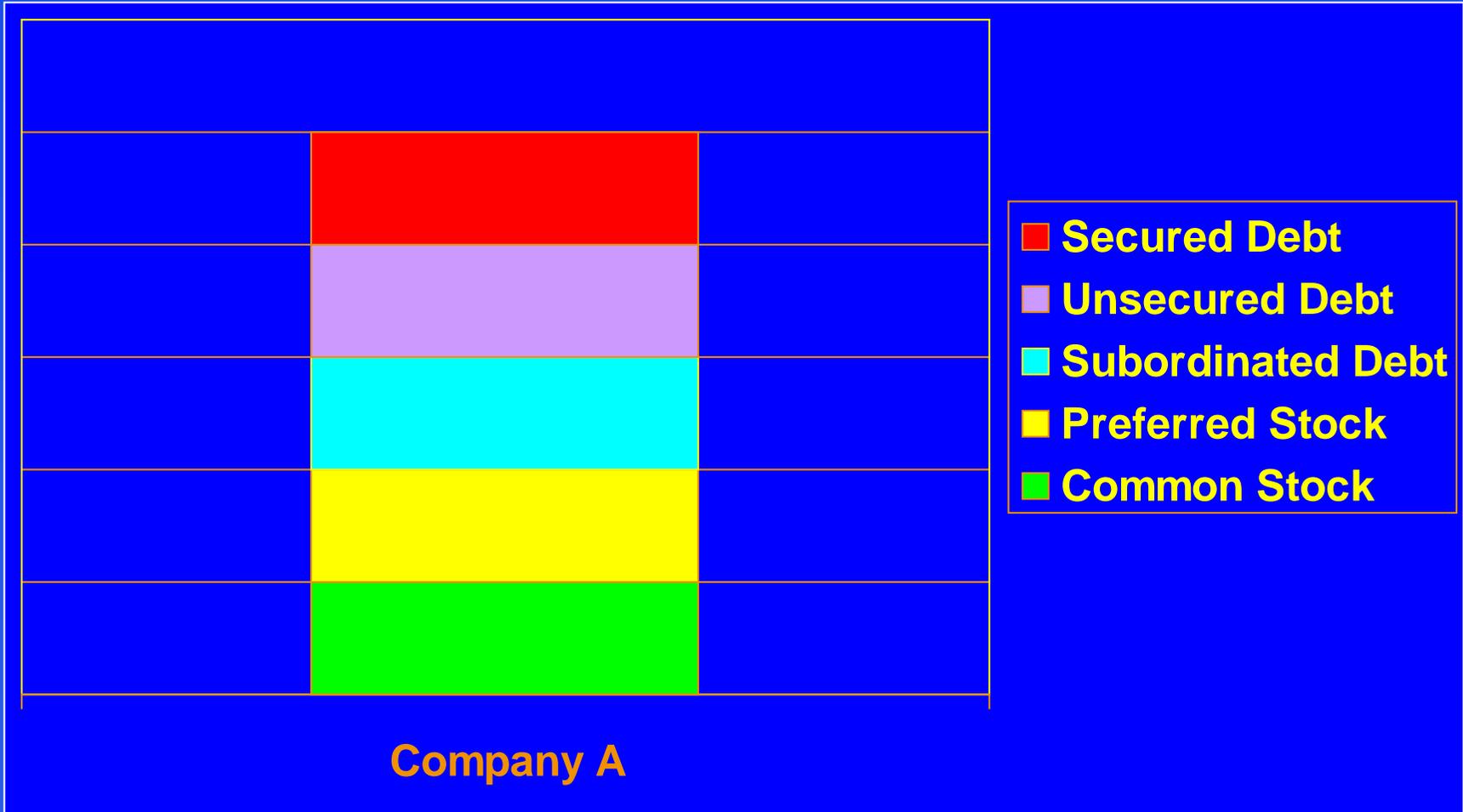
- When the Investor Writes the Check he has done most EVERYTHING he promised
- The Entrepreneur Has Done NOTHING YET

## □ Result:

- The VC wants its money to be paid back BEFORE the Entrepreneur gets his/her return.

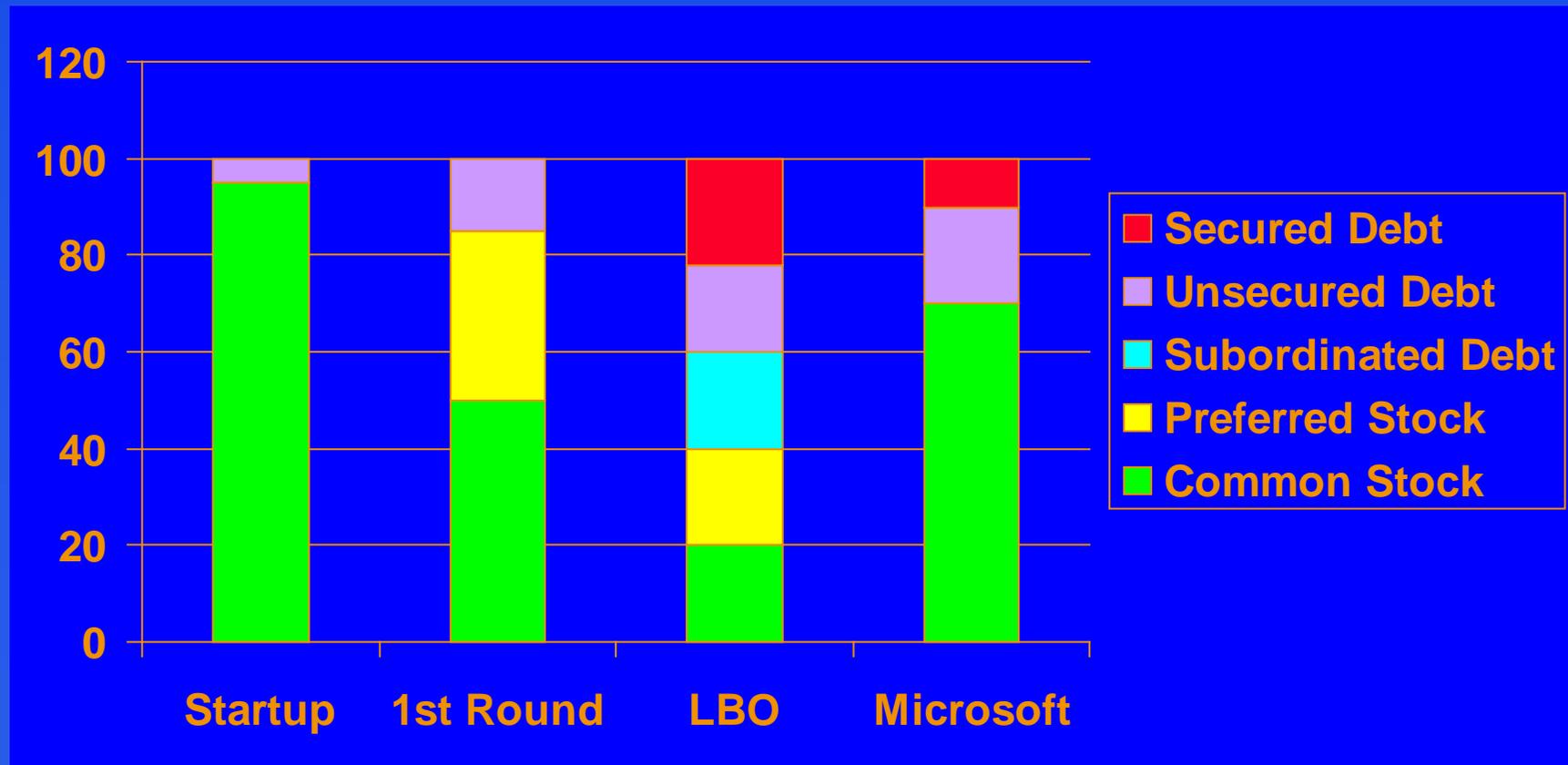
## □ Instrument: CONVERTIBLE PREFERRED STOCK

# Capital Structure Instruments



# Capital Structure Instruments

Percentage of Capital Structure By Stage/Type of Company



# A Preferred Return: Dividends

## **Dividends:**

**The Preferred Stock is entitled to an annual \$\_\_\_\_\_ per share dividend, payable when and if declared by the Board of Directors, but prior to any payment on Common Stock; dividends are not cumulative**

## **Dividends:**

- Paid to Preferred First**
- Cumulative or Accruing**

# A Preferred Return: Liquidation Preference

## Liquidation

### Preference:

The Series A Preferred will have a liquidation preference such that proceeds on a merger, sale or liquidation (including non-cumulative dividends) will first be paid to the Series A and will include a 10% per annum compounding guaranteed return calculated on the total amount invested.

- “Straight” Liquidation Preference: The Preferred receives its original investment amount plus accrued dividends (if any) before Common receives anything.
- Participating (“Double Dip”) Preferred: The Preferred first gets its liquidation preference and then shares any remaining proceeds with Common. Increasingly subject to a cap of 3X or 4X (including preference).



# Valuation and Participating Preferred

## WHICH IS THE BETTER DEAL FOR THE FOUNDERS?

- Case A: Founders sell 40% of the Company for 5m of Convertible Preferred Stock with a \$5m Liquidation preference but no participating rights. (\$7.5M pre-money valuation)
- Case B: Founders sell 33% of the Company for \$5m of Participating Preferred Stock (\$10m pre-money)

# Valuation and Participating Preferred

| Payout Schedule for Case A: 40% of the Company for \$5m of Nonparticipating Preferred |   |     |      |      |    |      |  |
|---|---|-----|------|------|----|------|--|
| Exit Valuation (\$M)  | 5 | 10  | 12.5 | 20   | 35 | 100  |  |
| Investors Payout (\$M)  | 5 | 5   | 5    | 8    | 14 | 40   |  |
| Founders Payout (\$M)   | 0 | 5   | 7.5  | 12   | 21 | 60   |  |
| Payout Schedule for Case B: 30% of the Company for \$5m of Participating Preferred    |   |     |      |      |    |      |  |
| Exit Valuation (\$M)  | 5 | 10  | 15   | 20   | 35 | 100  |  |
| Investors Payout (\$M)  | 5 | 6.5 | 8    | 9.5  | 14 | 33.5 |  |
| Founders Payout (\$M)   | 0 | 4.5 | 7    | 10.5 | 21 | 66.5 |  |

# A Preferred Return: Liquidation Events

- Liquidation, dissolution, sale of assets
  - money comes into corporation
  - money paid out to stockholders to redeem stock
- “Deemed liquidation”--merger or other positive event
  - consideration may be stock or cash
  - consideration may go directly to stockholders

# Major Deal Elements

- A Preferred Return
- Protection of Valuation and Position re: Future Money
- Management of the Investment
- Exit Strategies

# Protection of Valuation and Position re: Future Money

- Antidilution Protection
- Approval Rights

# Protection of Valuation: Conversion and Antidilution

**Conversion:** A holder of the Series A Preferred shall have the right to convert the Series A Preferred at the option of the holder, at any time, into shares of Common Stock. The total number of Common Shares into which the Series A Preferred may be converted initially will be determined by dividing the Original Purchase Price by the “Conversion Price”. The initial Conversion Price shall be the Original Purchase Price.

# Protection of Valuation: Conversion and Antidilution

## □ Conversion Events: When Does Preferred Convert Into Common?

- Voluntary
- Forced: often some % of Preferred can force conversion of all
- Automatic--upon "Qualified IPO"
  - » minimum total offering; minimum share price (usually 3 to 5 times initial purchase price)

## □ Conversion Ratio--initially 1:1

- Adjustments--stock splits, etc; **price antidilution**
- Exceptions--option pool, conversion of preferred, outstanding warrants, other existing conditions, other special exceptions

# Protection of Valuation: Conversion and Antidilution

## **Anti-Dilution:**

**Series A shall have weighted average anti-dilution, based on a weighted average formula to be agreed, for all securities purchased as part of this transaction (excluding shares, options and warrants issued for management incentive and small issues for strategic purposes of under 100,000 shares)**

# Protection of Valuation: Conversion and Antidilution

- Antidilution Adjustment increases the number of shares received on conversion of Preferred
- What Triggers Antidilution Adjustment?
  - Issuance or “deemed issuance” of Common at less than preferred issuance price
  - “Deemed issuance”--adjust upon issuance of derivative security; if common never issued, readjust later
    - » options, warrants
    - » convertible securities

# Protection of Valuation: Antidilution

- Conversion Ratio:
  - Original Purchase Price/Conversion Price
    - » Initially  $OPP=CP$  so Conversion Ratio =1
- “Full ratchet”: Conversion Price reset to equal price at which diluting security is sold
- “Weighted average”:  $CP_{new}=CP_{old} * R$ 
  - Where  $R = (N + M/CP_{old})/(N+S)$ 
    - » N = old shares outstanding (fully diluted)
    - » S = new shares to be issued
    - » M = new money (\$)

# Antidilution

|  |               | Rounds of Financing |                 |                 |
|--|---------------|---------------------|-----------------|-----------------|
|  |               | Series A            | Series B        | Series C        |
| Amount Invested                                  |               | \$ 7,000,000        | \$ 13,500,000   | \$ 5,000,000    |
| Round Stock Price                                |               | \$1.00              | \$5.00          | \$2.00          |
| Number of Shares                                 | 10,000,000    | 7,000,000           | 2,700,000       | 2,500,000       |
| <b>Normal Dilution</b>                           |               |                     |                 |                 |
| Common   | 100.00%       | 58.82%              | 50.76%          | 45.05%          |
| Series A   |               | 41.18%              | 35.53%          | 31.53%          |
| Series B   |               |                     | 13.71%          | 12.16%          |
| Series C   |               |                     |                 | 11.26%          |
|  | -----         | -----               | -----           | -----           |
|  | 100.00%       | 100.00%             | 100.00%         | 100.00%         |
| <b>Percentage Ownership After Series C Round</b> |               |                     |                 |                 |
|  | <b>Common</b> | <b>Series A</b>     | <b>Series B</b> | <b>Series C</b> |
| <b>Normal Dilution</b>                           | 45.05%        | 31.53%              | 12.16%          | 11.26%          |
| <b>Weighted Average</b>                          | 44.65%        | 31.26%              | 12.93%          | 11.16%          |
| <b>Full Ratchet</b>                              | 38.10%        | 26.67%              | 25.71%          | 9.52%           |

# Protection of Valuation and Position:

- Approval of Investors
- Pre-Emptive Rights
- Right of First Refusal

# Protection of Valuation and Position: Approvals

**Negative Covenants:** Approval by holders of Preferred Stock of organic changes outside normal course of business and sale, liquidation or merger, increase in board seats or change election procedures, new shares senior to or on par with and all distributions (dividends, repurchases).

- Approval of Investors Required For
  - New Financings
  - Merger or Sale of Company
  - Increase in Option Plan

# Protection of Valuation and Position: Pre-Emptive Rights

**Pre-Emptive Rights:** Holders of the Preferred Stock will be granted rights to participate in future equity financings of the Company based upon their pro-rata, as-if-converted, ownership of the Company.

# Protection of Valuation and Position: Pre-Emptive Rights

- Permits Investors to participate *pro rata* in future financings, to preserve their percentage ownership
- Subject to exclusions:
  - option pool issuances
  - strategic alliances & licenses
- “Pay to Play”

# Protection of Valuation and Position: Rights of First Refusal; Tag Along

## **Rights of First Refusal; Tag-Along**

**The Company and the Investors will have a right of first refusal with respect to any employee's shares proposed to be resold. Alternatively, the Investors will have the right to participate in the sale of any such shares to a third party (co-sale rights), which rights will terminate upon a public offering.**

# Protection of Valuation and Position: Rights of First Refusal; Tag Along

- Granted by Founders/other Investors
- First Refusal: Gives Investors the right to acquire shares offered by the grantor, *pro rata*
  - May be partial or “all or nothing”
  - Exclude: VC partnership distributions, estate planning
- Tag Along (Co-Sale): Gives Investors the right to sell shares *pro rata* if a Founder sells shares to others
  - Rarely invoked
  - Helps lock in Founders

# Major Deal Elements

- A Preferred Return
- Protection of Valuation and Position re:  
Future Money
- **Management of the Investment**
- Exit Strategies

# Management of the Investment

- Board Seat(s)
- Business Approvals
- Information Rights

# Management of the Investment: Board Seats

## **Board of Directors:**

**The Board will consist of \_\_\_ members. The holders of the Preferred Stock will have the right to designate \_\_ directors, the holders of the Common (exclusive of the Investors) will have the right to designate \_\_\_ directors, and the remaining \_\_\_ directors will be unaffiliated persons elected by the Common Stock and the Preferred Stock voting as a single class.**

## □ Board Seat(s)

- Importance of the “Independent Director(s)”

# Management of the Investment: Business Approvals

- Business Approvals
  - Capital Expenditures etc.
  - Approval of Annual Budget and Operating Plans

# Management of the Investment: Information Rights

## **Information Rights:**

**Monthly actual vs. plan and prior year. Annual budget 60 days before beginning of fiscal year. Annual audit by national firm. All recipients of financial statements to execute non-disclosure agreement acceptable to Company counsel. The aforementioned information rights shall be available to each holder of Preferred Stock for as long as such holder owns 220,000 shares of Preferred Stock or shares of Common Stock issued upon conversion of shares of Preferred Stock**

# Management of the Investment: Carrots and Sticks

## **Option Pool:**

**Simultaneously with this transaction, one million new shares shall expand the Company's management incentive stock option pool - bringing the total number of shares issued and stock incentives (awards and options) authorized to 6,100,000.**

## □ Option Pools:

- Traditionally 12% to 18% at Round One
- Two Year Pool

# Management of the Investment: Carrots and Sticks

## □ Vesting of Founders/Key Management Stock

### **Stock Restriction**

#### **Agreement:**

**All present holders of Common Stock of the Company who are employees of, or consultants to, the Company will execute a Stock Restriction Agreement with the Company pursuant to which the Company will have an option to buy back at cost a portion of the shares of Common stock held by such person in the event that such stockholder's employment with the Company is terminated prior to the date of employment. 25% of the shares will be released each year from the repurchase option based upon continued employment by the Company.**

# Management of the Investment: Carrots and Sticks

## □ Non-Competition and Invention Agreements

### **Non-competition, Proprietary Information and**

**Inventions Agreement: Each officer and key employee of the Company designated by the Investors will enter into a non-competition, proprietary information and inventions agreement in a form reasonably acceptable to the Investors**

# Major Deal Elements

- A Preferred Return
- Protection of Valuation and Position re:  
Future Money
- Management of the Investment
- **Exit Strategies**

# Exit Strategies

- IPOs and Registration Rights
- Sale/Acquisition
- Redemption of Stock

# Exit Strategies: Registration Rights

**Registration Rights:** Two U.S. demand registrations, subject to \$3 million and 500,000 share trigger, unlimited piggybacks, and evergreen S-3 if requested and possible all at company expense.

- Shares cannot be freely sold without filing a Registration Statement with the SEC
  - Only the Company can file
- So the Investors negotiate for certain Registration Rights to insure a contractual ability to exit into the public markets

# Exit Strategies: Registration Rights

- Enables Investors to sell shares publicly by means of a registered offering
  - Sales prior to end of 1-year holding period;
  - Avoid compliance with volume limitations of Rule 144
- Registration paid for by the Company
- Are Founders included?

# Exit Strategies:

## Demand Registration Rights

- Exercisable after the IPO or within 3-7 years of investment
- Can be exercised 1 to 3 times;
- Can be exercised by holders of 20-50% of the registrable shares, with value of [\$\$\$]

# Exit Strategies:

## Incidental (“Piggyback”) Registration Rights

- ❑ Investors “piggyback” on another registration
- ❑ Can they participate in other shareholders’ demand rights?
- ❑ Subject to underwriter “cutback”
- ❑ S-3 Registrations generally unlimited

# Exit Strategies: Redemption

## **Redemption:**

**If not previously converted, the Series A is to be redeemed in three equal successive annual installments beginning January 20, 2005. Redemption will be at the purchase price plus a 10% per annum cumulative guaranteed return**

- Redemption: The Company's repurchase of Preferred Stock at the demand of the Investors
- When Used: When the Company hasn't gone public
  - Because Founders Don't Want To
  - Because Business Doesn't Develop Into an IPO Type

# Exit Strategies: Redemption

- When Does Redemption Kick In?
  - Typically after Five (5) years
  - Often phased over Three (3) years
- Trigger
  - Automatic
  - Upon vote of Preferred
- Price
  - Initial Purchase Price paid plus accrued dividends
  - Sometimes additional return
- Different classes of preferred--later classes won't let earlier investors out first

# Conclusion

- Understand the Major Deal Elements
  - A Preferred Return
  - Protection of Valuation and Position re: Future Money
  - Management of the Investment
  - Exit Strategies
  
- Focus on Proving Your Valuation

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