

Everything You Ever Wanted to Know  
About Venture Capital  
Financing Terms

## Venture Capital Basics

*Part One of Three*

*By Marc Porter*

Editor's Note: This is Part One of a three-part series by Marc Porter. Throughout this fascinating series, Marc will share with us his in-depth knowledge of the intricate details associated with venture capital deals and the pros and cons associated with such contracts. Parts two and three will be printed in the February and March 2004 issues of *connect* respectively

All three sections may be read online at  
<http://www.connect-utah.com/article.asp?r=221>

Recent data indicates that venture capital investing is on the rise. While only time will tell, this is potentially good news for start-up and emerging growth companies in need of capital.

In making an investment decision, a venture fund will scrutinize a company's management team and its business plan, products and financial history and projections. If it decides to proceed with the investment, the venture fund will propose the terms of the financing in a "term sheet." Many of the terms in the term sheet will be unfamiliar and confusing to new and developing companies who have little or no experience with venture capital financings. The term sheet will speak of the investor's "liquidation preference" and "pre-emptive rights" and the investor's right to an "anti-dilution adjustment." Terms such as "drag-along right" and "pay-to-play" may cause the company's founders and management to wonder if they will be subject to serious bodily harm if the company performs poorly. And speaking of bodily harm, the company will no doubt have questions about the meaning of the investor's "piggy back rights!"

An understanding of these and other basic venture capital financing terms will enable the company to speak the venture fund's language. It will also enable the company to effectively communicate with its legal counsel in negotiating the financing. With this understanding, the company will be in a better position to negotiate more favorable terms and better appreciate the consequences (good and bad) of the financing. While a good venture capital fund will bring value to a company (not only in terms of the cash investment, but also relevant experience, contacts and industry knowledge), this added value will always come at a price and the company should understand what that price is.

This article discusses fundamental venture capital financing terms. For simplicity sake, it assumes that the company has issued only common shares to its founders and other employees, that it is engaging in its initial round of venture capital financing and that only one venture capital fund is participating in the financing. If the company is negotiating with multiple investors (as is often the case), the company will need to be mindful of not only the company-investor relationship covered in this article, but also the intra investor relationship and related issues. In addition, if there are existing investors, all or a percentage of the investors' consent will likely be required for any additional financing. For this reason, the company must negotiate terms not only agreeable to the company, but also acceptable to the existing investors.

### Pre-Money Value

Any discussion of venture capital financing should start with pre-money valuation. Pre-money value" refers to the company's value prior to the financing. Pre-money value is a critical figure because it is the basis for determining what percentage of a company an investor will own after its investment. The pre-money value will also impact whether existing shares are entitled to anti-dilution adjustment (discussed below).

#### Example: \$5 Million Pre-Money Value

- Pre-money value: \$5 million.
- Investment amount: \$5 million.
- Post-money value (pre-money value plus investment amount): \$10 million.

Because the investment equals half of the post-money value (or \$5 million of \$10 million), the investor owns 50% of the company.

#### Example: \$10 Million Pre-Money Value

- Same facts, except that the company's pre-money value is \$10 million.

Because the investment equals one-third of the post-money value (or \$5 million of \$15 million), the investor owns 33.33% of the company.

As the above examples illustrate, an investor benefits from a lower pre-money value because it is able to get more "bang for its buck." As the pre-money value decreases, an investor is able to purchase a greater percentage of the company. By way of contrast, the founders and other existing shareholders of a company benefit from a higher pre-money value because they are able to retain a greater percentage of the company. An investor will spend considerable time and effort evaluating and negotiating the pre-money value to ensure that it does not "buy high" as so many investors did during the technology boom when many companies were overvalued.

Determining pre-money value is often more art than science, but factors typically considered include:

- the value of the company's proprietary technology;
- product development and time to market;
- sales figures, if any;
- the value of similarly situated companies and
- the price per share for warrants, options or other securities recently issued by the company.

## Liquidity

An investor invests in a company with the express goal of earning a return on its investment. This return is typically earned when the investor sells its shares to a third party purchaser or receives cash dividends or other distributions from the company. Investors may receive cash distributions in the form of declared dividends or in connection with an asset sale, liquidation, winding up or dissolution of the company. However, start-up and emerging growth companies rarely declare dividends and, at the time of an investment in such a company, there will be no public market for its shares. An investor is therefore unable to sell its shares unless the company is sold, the company registers its shares for public sale, the investor is able to sell the shares to a third party in a private sale or the company agrees to repurchase the shares. This article does not discuss federal and state law restrictions on sales of shares in private offerings. An investor should consult legal counsel before engaging in such a transaction.

## Sale of Company: Liquidation Preference

A venture fund will almost always insist on preferred shares for its investment. The shares are "preferred" in the sense that they have certain rights, preferences and privileges that are senior to the rights, preferences and privileges afforded the common shares. One such preferential right is the "liquidation preference," which entitles the investor to receive a return on its investment in the event the company is sold, liquidated, dissolved or wound up before any proceeds from the transaction are distributed to the other shareholders. The liquidation preference can range from an amount equal to the amount invested (a "1X" liquidation preference) to as much as five times that amount (a "5X" liquidation preference). The company and its existing shareholders will push for a 1X liquidation preference, while an investor may seek a higher multiple. The consequences of these negotiations are significant.

### Example: 1X Liquidation Preference

- Outstanding capital: 10,000,000 common shares
- Pre-money value: \$10 million
- Per share value of outstanding capital: \$1.00
- Investment amount: \$5 million
- Number of preferred shares issued to investor: 5,000,000
- Liquidation preference: 1X
- Company sale price: \$15 million

The investor receives \$5 million, or 1/3 of the sale proceeds, and the common shareholders receive the remaining \$10 million, or 2/3 of the proceeds.

### Example: 3X Liquidation Preference

- Same facts except that the investor has a 3X liquidation preference

Because the investor is entitled to receive three times its \$5 million investment, it receives all \$15 million of the proceeds and the common shareholders receive nothing.

Whereas the first example resulted in a win-win situation for the investor and the common shareholders, the second example benefited only the investor. In fact, with a 3X liquidation preference, the company would have to be sold for \$25 million for

the common shareholders to receive a return equal to the \$10 million the common shareholders received in the first example. Furthermore, for the common shareholders to receive 2/3 of the sale proceeds as they did in the first example, the company would need to be sold for \$45 million.

The preferred shares in the above examples are "non-participating preferred" because the investor is entitled to receive an initial return on its investment but is not entitled to receive any of the remaining proceeds distributed to the common shareholders (unless it elects to forego its liquidation preference and convert its preferred shares into common shares). Even if the company in the above example is sold for \$20 million (an additional \$5 million), an investor with a 3X liquidation preference will receive no more than \$15 million of the proceeds. Accordingly, it is of no consequence to the investor whether the company is sold for \$15 million or \$20 million. For this reason, an investor may insist that it receive not only an initial return on its investment, but also a percentage of the remaining proceeds.

A participating liquidation right entitles an investor to receive, in addition to its initial return on its investment, a percentage of the remaining proceeds equal to its relative ownership of all shares entitled to participate in the distribution. In such an event, the preferred shares are treated as if they had been converted into common shares. In the case of an investor with significant leverage, these rights may be unlimited (the preferred shares being referred to as "fully participating preferred"). By way of contrast, a company will attempt to limit the participation right (the preferred shares being referred to as "partially participating preferred") to two to three times the investment. The following examples illustrate the differences between partially participating preferred and fully participating preferred.

### Example: Partially Participating Preferred

- Outstanding capital: 10,000,000 common shares
- Pre-money value: \$10 million
- Per share value of outstanding capital: \$1.00
- Investment amount: \$5 million
- Number of preferred shares issued to investor: 5,000,000
- Liquidation preference: 1X, participating up to 2X
- Company sale price: \$25 million

The investor receives \$5 million for its 1X liquidation preference. Because the investor owns 5,000,000 of the 15,000,000 combined common and preferred shares, the investor is entitled to receive 1/3 of the remaining \$20 million until the investor has received an additional \$5 million. The investor receives \$10 million, or 2/5 of the proceeds, and the common shareholders receive \$15 million, or 3/5 of the proceeds.

### Example: Fully Participating Preferred

- Same facts except that the liquidation preference is fully participating.

The investor receives \$5 million for its 1X liquidation preference. Because the investor owns 5,000,000 of the 15,000,000 combined common shares and preferred shares, the investor receives 1/3 of the remaining \$20 million, or \$6.67 million. The investor receives a total of \$11.67 million, or 46.7% of the proceeds, and the common shareholders receive a total of \$13.33 million, or 53.3% of the proceeds.

Because the liquidation preference in the second example was fully participating, the investor received \$1.67 million more (and the common shareholders received \$1.67 million less) of the proceeds than it received in the first example.

As a condition for participation rights, founders and other large common shareholders may negotiate the right to receive a portion of the proceeds equal to the amount received by the investor (either on a per share or aggregate basis) before the investor participates in the distribution of any remaining proceeds. This "catch up right" is an effective means of leveling the playing field to the benefit of the common shareholders.



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## Drag Along Rights

In addition to the liquidation preference, an investor may want greater control over the timing of a liquidation event (and consequently its exit strategy) through a "drag along" right. A drag along right gives an investor (or a certain percentage of investors) the right to force all or most of the shareholders to vote in favor of a sale of the assets or shares of the company. The investor obtains this right by causing all or the requisite percentage of shareholders to enter into a voting agreement or grant an irrevocable proxy to the investor to vote their shares in favor of a liquidity event. A drag along right may be limited to transactions that are approved by the board of directors or transactions that equal or exceed a predetermined minimum sale price. [fin](#)

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