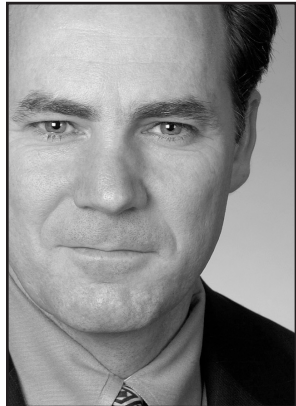


Running the Numbers: Determining the Impact of Select Deal Terms

BY JOHN L. CLEARY II AND DARREN C. WALLIS



John L. Cleary II

As the market for venture capital dollars has steadily rebounded over the past few years from the declines of 2000 to 2003, we have seen entrepreneurs receive multiple term sheets, competing offers and contemplate alternative financing strategies. As with any significant transaction, it is imperative that entrepreneurs consider carefully with your advisors all the deal terms and alternatives available to you with a view toward realistic and attainable exit scenarios. While valuation is high on the list of important deal terms, be careful to consider all material terms (including preferences, dividends, option pool, etc.) and run the numbers under multiple scenarios to determine their impact on future financing rounds and each stakeholder's ultimate payout. The highest valuation does not always mean more money in your pocket. Consider the following real life transaction.

A software company seeking to raise \$8 million receives two term sheets: "VC Firm A" proposes a participating preferred at a pre-money valuation of \$25 million and requires a post-money option pool of 15 percent (Term Sheet A). "VC Firm B" proposes a non-participating preferred with a 2X liquidation preference at a pre-money valuation of \$16 million and requires a post-money option pool of 13 percent (Term Sheet B). While the pre-money valuations are off significantly, running the numbers shows in certain cases Term Sheet B provides the founders with a greatest return on exit.

As a threshold matter, founders must understand the differences between a participating and a non-participating preferred stock. With a participating preferred stock, upon an exit the investors are entitled to the return in full of the original investment (the Liquidation Amount) prior to any payout to the founders, plus the investors also participate with the founders on a pro rata basis in any proceeds in excess of the Liquidation Amount. With a non-participating preferred stock, upon an exit event the investors are entitled to either the return in full of the Liquidation Amount or their pro rata share of the total proceeds.

Under Term Sheet B, the investors have a 2X liquidation preference which means that the first \$16 million of exit proceeds (\$8 million- x-2) will go to the investors. As such, the founders will not share in any proceeds until the exit value exceeds \$16 million. Thereafter, the founders will take all of the exit proceeds in excess of \$16 million until the exit proceeds reach \$48 million (the flipping point where the preferred investors will convert their preferred stock into common stock so as to receive proceeds in excess of their 2X liquidation preference).

Another important point to note is that with a participating preferred stock the investors' percentage share of the exit proceeds is significantly

in excess of their share ownership percentage, particularly at lower exit valuations, and as the exit valuation increases, the benefit of the participation element is reduced until the investors' share of the exit proceeds approaches, but does not actually equal, their true ownership percentage.

A review of the numbers (a detailed presentation of the numbers is beyond the scope of this article) shows that at lower valuations the participating preferred stock of Term Sheet A is more economically favorable to the founders as they at least share in some of the exit proceeds once the exit value exceeds the lower \$8 million liquidation

preference. Term Sheet B provides the investors with true downside protection by taking more of the exit proceeds at lower valuations. Upon a \$20 million exit, Term Sheet A provides the founders with \$7.2 million, or 36 percent of the proceeds (significantly below their 61 percent equity ownership), as opposed to only \$3.2 million, or 16 percent of the proceeds under Term Sheet B.

As the exit valuation approaches the "flipping point" of the preferred stock under Term Sheet B, the pendulum swings back in favor of Term Sheet B as the more favorable to the founders. Upon a \$40 million exit, the term sheets provide roughly equivalent value to the founders and at a \$50 million exit (just beyond the flipping point), Term Sheet B provides the founders with \$26.67 million (53.3 percent of the proceeds), as opposed to only \$25.4 million (51 percent of the proceeds) under Term Sheet A. (Note that the proceeds allocated under Term Sheet A are still below the founder's 61 percent equity ownership due to the participation element, but the gap is starting to narrow).

In this example, Term sheet B remains the more economically valuable to the founders

from exit values of \$50 million until about \$70 million where the investors' share of the exit proceeds taking into account the participation element approaches and crosses below the investors' share of the proceeds on an as-converted basis under Term Sheet B (which is 33 percent). The bottom line is that Term Sheet A is more favorable to the founders at lower exit valuations, the differences come together and Term Sheet B becomes more valuable at middle of the road valuations with a flip back to Term Sheet A at higher valuations.

The foregoing example can be modified for additional deal terms, such as adding cumulative dividends, playing with the option pool number, etc., to take into account all variables when negotiating your term sheet. These examples illustrate the need to run the numbers, even if you have only one term sheet, so as to gauge the true impact of selected deal terms and determine each party's true return on exit.

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Darren C. Wallis

John Cleary is a partner resident in the New Jersey office of Sonnenschein Nath & Rosenthal, LLP and a member of the Corporate Department and the Venture Technology Practice Group. Darren C. Wallis is a managing partner with Osage Ventures.