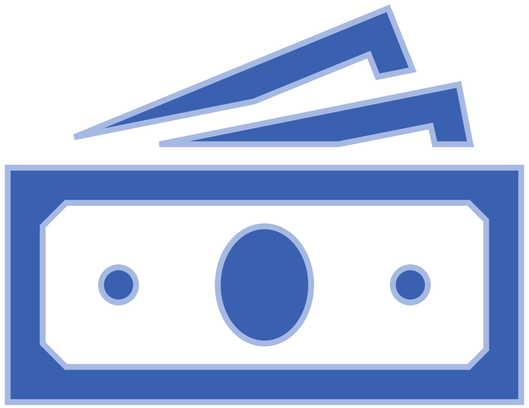
CAPITAL RAISING AND OVERVIEW OF VENTURE CAPITAL

TODAY WE ARE JOINED BY SABRINA CONYERS AND AARON FYKE

INTRODUCING CAPITAL

DEFINITIONS

- Capital
  - Financial and other types of resources required to obtain the necessary assets to launch a business, to keep it running, or to expand it
- Capital assets
  - Assets obtained and used on an ongoing basis for the purpose of generating revenue



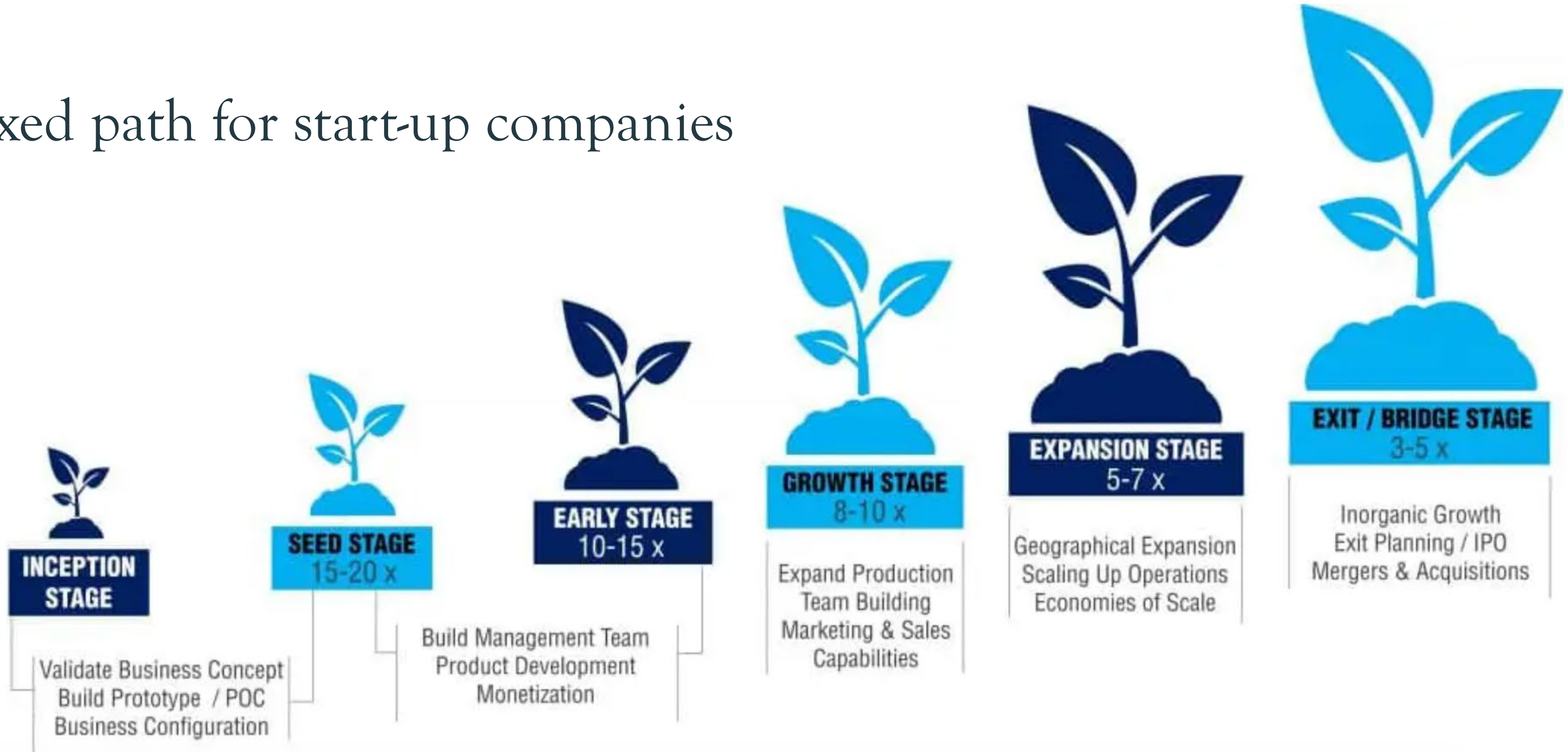
THE NEED FOR CAPITAL

$ EVERY new business is going to need capital

¥ The amount of capital required to start a business is a function of the type of "capital assets" that the business needs coupled with the length of time needed to fund the operating costs of the business

STAGES OF INVESTMENT

- No fixed path for start-up companies



FORMATION FUNDING

The first capital received

Often from yourself or your family/friends

Often begins informally

Handshake deals

No detailed documentation

Can also look similar to seed stage round with detailed documentation

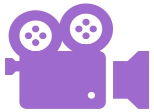
SEED STAGE

- Increasingly critical to bringing product to market and obtain funding
- Can include more formal rounds of capital raising efforts backed by angel investors, angel networks or seed funds
- Helps a start up achieve
  - Product identification
  - Marketplace research
  - Demographic targeting
  - Establishing a broader team to create or launch a product

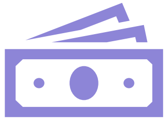
SEED STAGE CONT.

- Types of investments:
  - Convertible notes
  - Equity, and/or
  - Other similar investments
- Seed investments are more common because bar for Series A round is heightened
  - Intense diligence
  - Heightened scrutiny

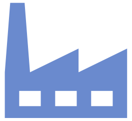
START-UP OR EARLY-STAGE FUNDING



Series A Round



Often the first round of formal financing



Company is still at an early stage of development but now has

- Demonstrable product, prototype, or other proof of value
- A core management team
- Existing or well-planned business structure
- Focus on marketing and distribution channels

To succeed in this round, the company needs a business plan and product to demonstrate to potential investors

EXPANSION STAGE FUNDING

Series B Funding

Investors expect to see a company with an operational or nearly operational business

Start-ups use this stage for "scalability"

This stage also involves

- Hiring additional employees
- Increasing space/equipment, additional salaries, benefits, administrative costs, etc.)

LATER STAGE FUNDING

There really is no limit to the number of investment rounds that a company can pursue and the reasons for pursuing such funding is varied

Companies at this stage are growth oriented and typically seeking to position for an ”exit event”

IPO, SALES, AND "ACQUI-HIRES"

- These are the exit events that later-stage companies often seek
  - Can also be referred to as a "liquidity" event
- Often are sales to competitors or other strategic acquirers
- BUT there is one variation on a sale of a company that involves an "acqui-hire" transaction
  - The buyer wants to acquire the talents and expertise of the seller's employees instead of the products, services, or technology which will often be abandoned after the acquisition
  - Maximizes consideration paid to the desired employees
  - Can be lead by large companies (i.e. Google) and/or involve strategic acquisitions of start-up companies by other startups or early state companies

IPO, SALES, AND "ACQUI-HIRES" (CONT.)

- IPOs are the other major form of an exit transaction for venture-funded start-ups
- Raise significant capital and broaden the company's shareholder base (including institutional investors and the general public)
- Commentators question whether an IPO represents a true liquidity event or if it is simply another form of capital raising/funding because the company continues to exist
- Do not automatically convert pre-IPO ownership to cash but IPOs can trigger the automatic conversion of preferred stock into common stock

CAPITAL: WHO PROVIDES IT?

SELF-FUNDING

"bootstrapping": you use the business to generate the cash needed for its own growth (organic growth) or you borrow to fund growth

Presents disadvantages

- The market is not stopping, window of opportunity may close
- Possibility to get into serious financial trouble, needs of the business are often greater than predicted
- Losing out on potential collaborative benefits

But there are advantages

- Maintain full ownership
- Avoid the time consuming and difficult process of looking for capital
- Will not have to deal with potential disruption of adding other owners
- Shows commitment to the business and is viewed positively by outside investors

FRIENDS AND FAMILY FINANCING

Benefits

- Involves some of the same benefits as the self-funding, but increases the pool of resources available to the entrepreneur
  - However, it requires them to know people who are capable of investing
- Family and friends tend to request a smaller part in exchange for investing
  - Generally, not interested in the management of the company… a silent investor with less interference in day-to-day

Disadvantages

- A small, one time investment
- The tension in the relationship if the business fails

OUTSIDE INVESTORS

- Strategic Investors
- Angel Investors
- Seed Funding Firms
- Venture Capital Funds
- Corporate Venture Capital Funds
- General Public

STRATEGIC INVESTORS

- A strategic investor is one that invests for direct financial gain but also to further its own business objectives
- Issues that arise
  - Inability to allocate management and decision-making authority
  - Concerns regarding the sharing of financial risks and benefits
  - Who has control of the intellectual property
  - The strategic goals of the parties may not be aligned and can diverge over time
- As a result of all the possible issues, it will be costly to engage in a strategic investment opportunity because of all the issues that must be dealt within the complex multi-party relationship

ANGEL INVESTORS

- Many angel investors are retired entrepreneurs or business executives who invest in the industries they devoted their careers to – they offer experience and capital
- There is a growing network of angel investors or groups
- Typically have more financial resources than friends and family
- HOWEVER
  - Angel investors are still hard to find and are very selective in investment choices
    - Connect with start-ups thru personal connections or introductions
  - Drive a harder bargain than friends or family and will want more risk protection terms to accompany their investment, requiring expensive lawyers
  - Often only good for a one-time investment
  - Personal compatibility should be assessed

SEED FUNDING FIRMS

- Seed firms, sometimes called incubators, and venture capitalists perform the same function in that they invest private capital into high-risk ventures
- The primary distinctions between the two lie:
  - in their portfolio companies' stage of development
  - investment strategies
  - the amount of capital invested in portfolio companies
- Seed funding strategy
  - Invest small amounts in only the early stages as part of their business, rather than as a personal adventure/choice
  - Varies greatly
  - Incubators – help generate and cultivate business innovation and the start-up will often function within the "incubators" space
  - Accelerators – work with existing companies to accelerate growth and offer access to mentors and networks of experienced entrepreneurs and investors

VENTURE CAPITAL FUNDS

- These are forms of private equity that typically take the form of investments in the equity of privately held companies
- They invest in earlier stage, higher-risk companies that have a demonstrable product and are in a position to execute a business plan
- Some VC firms focus on seed-stage investments and others on later-stage portfolio companies.

CORPORATE VENTURE CAPITAL

- These typically operate as subsidiaries of established companies and most often make strategic investments related to the business of the parent company
- In some respects, the funds function similarly to that of traditional VCs in that they invest in portfolio companies in exchange for equity ownership, board representation, and other investor rights
- Technology companies often dominate the corporate VC landscape
- What is the motivation for forming a corporate VC?
    - Maintaining competitive advantage
    - Keeping abreast of technology developments
    - Negotiate strategic acquisitions/partnerships
- Promote "intrapreneurship" and exploration of high-risk, high return start up investments

THE GENERAL PUBLIC

- Crowdfunding through the general public using the internet and apps
- SEC regulations still apply to limit capital raise and types of investors
- Crowdfunding Statistics 2021 (published December 16, 2020)
  - $17.2 billion is generated yearly through crowdfunding in North America
  - Funds raised through crowdfunding grew 33.7% last year
  - There were 6,455,080 worldwide crowdfunding campaigns last year
  - Successful crowdfunding campaigns have raised $28,656 on average
  - The average amount raised by all crowdfunding campaigns last year was $824
  - 22.4% is the average success rate of crowdfunding campaigns.
  - Overall crowdfunding projects have an average of 47 backers and fully funded projects have an average of 300 backers
  - The average pledge for fully funded projects is $96 and $88 all crowdfunding projects
  - The crowdfunding market is projected to grow to $300 billion by 2030
  - Source - https://www.fundera.com/resources/crowdfunding-statistics

CAPITAL: WHAT MUST YOU GIVE TO GET IT?

CAPITAL FOR DEBT

- A loan has the advantage of providing money without reducing the founders' ownership interest
  - Requires repayment (generally monthly) regardless of the success of the business
  - Will also be required to begin repayment even if the business has not started bringing in revenue
- There are two significant reasons why a lender would insist on an ongoing repayment plan
  - Delaying collection increases the risk that the loan may never be paid
  - IRS treats accrued interest as taxable when it is "earned" regardless of whether a current interest payment is received or is deferred until a later date
- Ability of company to make debt repayments over term of the loan must be carefully considered

THE STRUCTURAL LIMITATION OF DEBT

Debt is not well suited for a high-risk investment in a start-up company because a lender is ALWAYS taking the risk that less than the full amount of the loan will be repaid with no ability to participate in the company's success

But an investor in the equity of a company always has the chance that they will make more back than what they have invested

Because there are structural limitations and the high risk involved, most investors will not conclude that the opportunity for profit on debt justifies the risk of loss

Raising capital through debt is unattractive to the investor because of the structural limitations requiring a current payment stream and unattractive to the lenders/investors because of the high risk associated and the prospect for a suitable return

CAPITAL FOR COMMON OR PREFFERED STOCK

The simplest equity investment vehicle is common stock

- Common stock is the highest risk security by virtue of being the LAST priority in the event of a liquidation or sale
- However, it gets all the extra value in the company

Preferred stock (hybrid between debt and equity), which will not be discussed in detail today, will be reserved for issuance to professional VC and other institutional investors

CAPITAL: PATHS FOR RAISING IT

PRIVATE PLACEMENTS

- Can become exempt from the registration requirements of the 1933 Act by selling securities to accredited investors found for it by an investment banker or a finder, which is referred to as broad-based private placement
- Investment banker assists in structuring an offering document, developing the terms of the security, and negotiating with the investors
  - A finder is unlicensed and must avoid doing the things an investment banker does
- Generally need a PPM to describe the investment opportunity, information on the business and industry, financial data and the risks of the investment.
  - Expensive and time consuming to prepare
  - PPM is a sales and marketing tool and an insurance policy
  - Lack of sophistication among investor pool can cause investor relation problems

FRANCHISING

- Sells a template of the business to a franchisee, so that when the franchised business opens, it operates the same as all other businesses franchised under that name

PUBLIC OFFERINGS

- Pass by all private financing issues and instead go straight to the stock market and become a public entity
- But this is difficult/impractical because a start-up is not prepared to meet the obligations of the public market
  - Public offerings are expensive, and a start-up would not draw in a large amount of money
  - Once public, regulatory and compliance reporting are time consuming, burdensome and expensive as well.
- A mini public offering under Regulation A+ may be an alternative to a traditional IPO
  - Need an active secondary resale market

ANY QUESTIONS?

BREAK TIME!!

VENTURE CAPITAL AND VENTURE CAPITAL INVESTORS

INTRODUCTION TO VENTURE CAPITAL

- Venture capital is private investment capital in high-risk ventures
- Can accurately be called "private equity"
- VCs invest in earlier-stage, high risk companies and is more of a multi-faceted process than a single specific financial act
- Very few businesses will qualify for financing under the strict criteria used by VCs
- As such, it represents only a fraction of the private investment capital deployed in the US each year but gets attention that is vastly disproportionate to its size

INTRODUCTION TO VENTURE CAPITAL (CONT.)

- Pros
  - Deep pockets, plan to make initial and subsequent investments
  - Deep industry knowledge and contacts
- Cons
  - Insist on playing a major/active role in the management of the company and its business
  - Demand a large portion of the company's ownership
  - Will sit on the board and introduce a new and more demanding level of oversight
  - Insist on rocket-speed growth, which entails risk

RECENT HISTORY OF THE VENTURE CAPITAL INDUSTRY

The growth of VC investing over the last 40 years has been dramatic

Why?

THE VENTURE CAPITAL FUND

FUND STRUCTURE

- Limited partnership
  - VCs are typically organized as limited partnerships with a limited liability entity, such as an LLC, serving as a general partner
  - The actual venture capitalists control the general partner
  - GP capital is 1% and LP capital is 99%
  - Favorable flow through tax treatment
  - Assets may be distributed to partners without taxation
    - Partners receive the assets with the tax basis the partnership had and no taxable event will occur until the partner sells the asset and a capital gain is recognized
    - Assets distributed usually consist of the stock received by the fund in exchange for its investment in the companies it has funded

FUND STRUCTURE (CONT.)

- GP compensation structure
  - Make money in two ways
    - For operating the fund's general partner, they receive an annual management fee
      - Usually set at 1.5-3 percent of the total committed for investment in the fund
      - May be waived to fund a portion of GP's capital commitment
      - Tax structuring is important
    - From an override interest in the fund's profits, often referred to as the "carry" or the "carried interest"
      - Funds often require an IRR hurdle to be achieved before the carry kicks in
      - Typical carried interests shifts from allocations of 1 to 99 percent to 20 to 80 percent
    - Carry claw backs are typical in partnership agreements

FUND STRUCTURE (CONT.)

- Tax controversy
  - The general partner’s carry also raises some controversial tax policy issues
  - The grant of an interest in partnership capital in exchange for services is taxable as ordinary income
  - BUT the grant of an interest in future partnership profits in exchange for services is NOT taxable as ordinary income because the value of that interest is too speculative to be taxed when granted (a “profits interest”)
    - As a result, no taxable event occurs on the grant of the carried interest
  - New tax rules under Sec. 1061 of the IRC apply to convert capital gain earned on a carried interest to ordinary income under certain circumstances

THE LIMITED PARTNERS

- The role of limited partners
  - Provide most of the money to venture capital funds
  - Rely on venture capitalists to manage the limited partnership
  - Who?
    - Typically financial institutions and money managers
    - Corporations, wealthy individuals, foundations, business associates of the venture capitalists who are often looking to build or cement their relationship with the VC

THE LIMITED PARTNERS (CONT.)

- Securities issues regarding limited partners
  - There are legal constraints on who can invest in venture capital partnerships because the sale of interests in a VC is a sale of securities
    - Must file under the 1933 Act or must qualify for a registration exemption
  - The problem arises, however, from the Investment Company Act of 1940, subjects fund to enhanced fiduciary duty requirements, limitations on transactions with affiliates, restrictions in making changes to management or making distributions without investor approval and other SEC regulatory requirements.
  - Two exemptions are typically used
    - §3(c)(1) exempts private securities issuers whose outstanding securities are held by 100 or fewer investors
    - §3(c)(7) exempts a private issuer that sells its securities to "qualified purchasers", higher standard than accredited investor

OPERATING THE FUND

- Set-up and Strategy
  - Much like starting any other business
    - Team of qualified people form a strategy and seek to raise capital necessary to execute the strategy
    - When seeking investors, the VCs prepare a PPM explaining their strategy, describing the team, and providing the financial and structural details of the fund
    - Prepare the limited partnership agreement, form their general partnership entity, and set up the target fund size

OPERATING THE FUND (CONT.)

- Capital Commitments
  - The limited partners make an investment commitment to the venture capital fund, which is the maximum amount that they may be called upon to deliver over the life of the fund
    - The fund may call less, but may not call more
    - The limited partners do not deliver all their money at the outset but instead deliver their investment to the fund in pieces over the life of the fund in response to "capital calls" made by the general partner
      - Cannot "opt-out" of responding to a call
        - Failure to comply would lead to breach of contract claims but the agreement would also
          - Bar the partner from further investments and
          - Require the partner to forfeit to the other limited partners some or all of its already invested interest in the fund
  - Once invested in the fund the investor's IRR calculation begins to run

THE ECONOMICS OF VENTURE CAPITAL INVESTING

Time Value of Money

- The fundamental issue for a lawyer to grasp in order to understand how venture capitals decide whether to invest in a company is the time value of money
- Given the extremely high rate of returns targeted by venture capitalist funds
  - The money should not be invested in a company until it actually can be used to increase that company’s value
  - The faster a company can get to a point where the investment can be cashed out, and the proceeds paid to the limited partners, the better the annualized return will be

Investment amounts

- The amount invested is determined by the company’s capital needs in order to achieve its business plan
  - Prefer that large investments be deferred until later in a company’s life so that large investments will not be outstanding for a lengthy period of time

TAKING ON A VENTURE CAPITAL INVESTMENT

PREPARING A COMPANY FOR VENTURE CAPITAL INVESTMENT

As counsel, the first task is to focus on clarifying the goals of the company's founders and current shareholders

- Rapid or organic growth?
- Plans to pass the business down to children?

Company must also

- Create the outline of the business plan
- strengthen the management and professional team
- develop a detailed business plan
- prepare them for the effort needed to secure VC funding

MAKING VENTURE CAPITAL INVESTMENT WORK

the process to secure VC funding will often take several months

What the company needs to do

Understand why the VC is looking for in their portfolio companies

Identify which venture funds specialize in its industry

Figure out the best way to present the company to the VC

MAKING VENTURE CAPITAL INVESTMENT WORK (CONT.)

- Preparation before seeking investors
    - Depends on the VC fund you are hoping to attract
    - Some utilize business plans
        - However, others will rely on
            - The credibility of the person who introduced the founder to the VC
            - Whether the founder has a proven track record
            - The available evidence of a market for the product being proposed

MAKING VENTURE CAPITAL INVESTMENT WORK (CONT.)

- What to include in a business plan?
  - The company
  - The market and competition
  - The product
  - The business model
  - The operation of the business
  - The financials

MAKING VENTURE CAPITAL INVESTMENT WORK (CONT.)

- You have to find a suitable potential investor by combing through the choices with an understanding of the criteria that the various venture funds use in selecting companies
  - Location
  - Does the VC invest in your industry?
  - Does the VC invest in companies at your stage?
  - Will the VC "lead"?
  - What is the best way to get in touch with them?

MAKING VENTURE CAPITAL INVESTMENT WORK (CONT.)

- Living with venture capitalists
  - As stated, VCs become more active in the management of their portfolio companies
    - Monthly board meetings with their representatives on the board with observation rights
    - Participate in all major decisions and will be involved in filling all management positions as the company grows
  - Have to find a way to maintain the equilibrium between keeping the VCs sufficiently informed without constraining the day-to-day operations