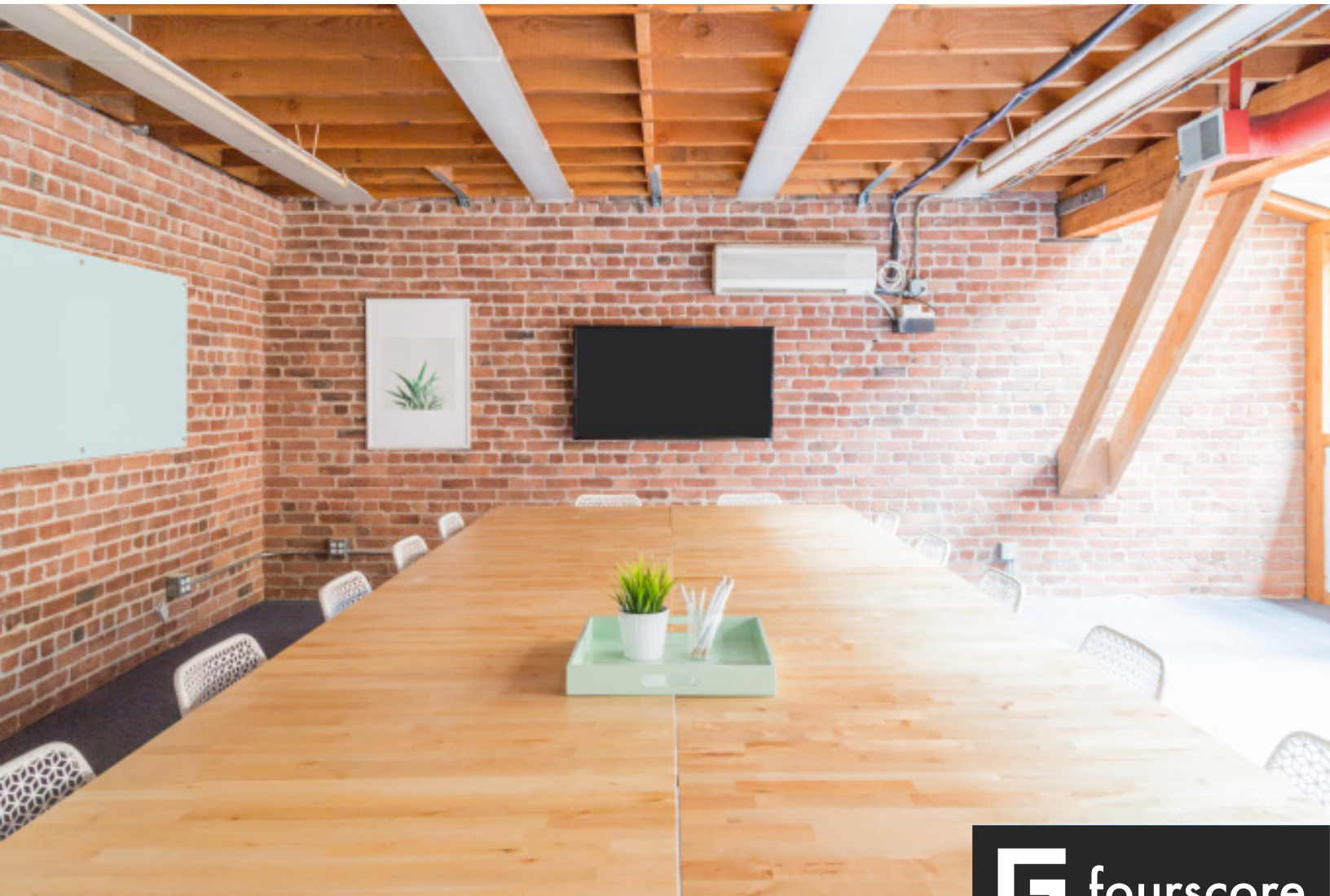


RAISING ANGEL & VENTURE CAPITAL

A GUIDE FOR NEW ENTREPRENEURS





YOUR GUIDE

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WHY SEEK OUTSIDE CAPITAL?

For entrepreneurs the prospect of raising funds to propel business growth should come with a mix of excitement and fear. While taking angel and venture capital isn't right for every startup, it may be the ideal financial structure to help you scale. Venture capital gives you the opportunity to raise significant amounts of funding by essentially selling a part of your company as you build it.

For that reason, entrepreneurs should understand that angel and venture capital is typically expensive money, so the smartest entrepreneurs

will make sure to seek outside capital from those that can provide value in terms other than simply dollars.

If you are planning to meet with a potential investor, understanding what to expect when it comes to structuring venture deals will help ensure you get started on the right foot.



Tip #1: Investor Pitching

Before you meet with a potential investor, do your research. Know the industry they typically invest in, at what stage they are comfortable investing, what size check they will write, their investing strategy and some of the companies in their portfolio.

STRUCTURING THE DEAL: EQUITY

Valuation

When a venture deal is structured as a sale of equity (normally in the form of preferred stock), investors and founders must agree to the amount that your company is worth. Determining valuation in the early stages, especially pre-revenue, generally becomes a negotiation game based more on market norms than anything else. It is in the founder's best interest for the company to receive a higher valuation, while a lower valuation is in the investor's best interest. However, the goal for a founder is to show consistent growth in valuation over time and between financing rounds so it is important to realize that an overinflated value in an early round can be detrimental in the long run.

Although market norms are very important to understand, you should also gather the following information in preparation for meeting with a potential investor:

1. Value of physical assets (if any)
2. A listing of intellectual property (particularly patents)
3. Attributes of founders and employees that help set your company apart from the

competition

4. Current customers, contracts and revenue (or your strategy for customer acquisition and revenue generation)
5. Information on similar companies who have recently received funding
6. Details on market size and growth projections
7. Competitor research

Although the valuation of the Company is important, founders will do well to accept funds from investors based on several other factors. Taking the check is the beginning of a long relationship and it is important to build that relationship with the right investors.

Protective Provisions

Investors are inherently accepting a measure of risk when supplying capital and protective provisions give them a level of control over the company in exchange. These provisions grant investors the right to block or veto certain actions, providing them protection from getting dragged along by majority stockholders.

Investors can negotiate for consent rights as they see fit, but some of the most common protective provisions are aimed at changes to the charter and/or bylaws, sales of the company or its assets, executive compensation, increasing or decreasing the number of directors, creating and selling shares that have “better” rights than the investors have, borrowing money (or maybe a threshold).

Liquidation Preferences

Liquidation preference comes into play when a company is sold. Preferred stockholders receive payment before common stockholders. Many deals include a 1x liquidation preference, meaning the owner will receive the return of the original purchase price of the preferred stock, plus any declared but unpaid dividends. 2x, 5x or greater liquidation preferences are also possible, where the owner would receive 2 times or 5 times their original investment before common stockholders receive anything. However, 1x liquidation preferences are the most common.

Participating vs. Non-Participating Preferred Stock

There are two forms of preferred stock: participating and non-participating. Holders of participating preferred stock, after receiving their liquidation preference, will “participate” in the distribution of assets to the common stockholders that follows. In essence, holders of participating preferred stock get to have their cake and eat it

too. If the preferred stock is non-participating, then the investor receives their liquidation preference and nothing more.

You may be wondering, “Why would anyone choose non-participating preferred stock if they just get their money back?” Which brings us to “conversion.” Almost all non-participating preferred stockholders have a right to conversion, meaning they may choose to convert their preferred stock to common stock if it works in their favor. In this case the owner may wait to see what the company is sold for, then opt to keep his/her liquidation preference OR give up the liquidation preference and convert the preferred stock into common stock (normally on a 1:1 ratio).

Price Protection

Now that you understand the basic financing structure, it’s important to consider your options for anti-dilution provisions. These price protection provisions are created to ensure your investor’s shares do not become overly diluted by future investor deals. When a venture capitalist invests in your company they will request assurance that you will not sell future shares at a lower price, diluting the value of their shares. Price protection provisions can be complicated and difficult to decipher, but understanding these two main variations will help you proceed.

Full Ratchet Price Protection

Full ratchet price protection means that if even one share is sold to a future investor at a lower price, the shares sold in the earlier round are essentially re-priced to the share price used in the current financing, which changes the conversion ratio. While full ratchet is relatively easy to understand, it can be very harmful to founders and is uncommon in my experience. It can also be risky for investors because it can make future fundraising more difficult.

Weighted Average Price Protection

While weighted average price protection may be complex, it is the most common and oftentimes best option. Weighted average price protection takes into consideration the number of later-sold, lower-priced shares and offers proportional protection. Most people in the venture community agree that weighted average anti-dilution protection is more appropriate than full ratchet, and you'll rarely see full ratchet protection (at least until we start seeing more down-rounds).

Board Matters

Representation on the Board of Directors is a point of negotiation, depending on the investor and company preferences. In general, earlier stage investors may or may not want a board seat, while later stage deals will almost always include board representation. Depending on the size of your Board and the number of investors, investors may control a majority of the Board. The benefits of

having an investor hold a Board seat can include greater access to expertise, strategic connections and industry knowledge.

Pre-emptive Rights

Pre-emptive rights act as another form of anti-dilution protection for investors. This protection gives investors the right to participate in the company's next issuance of securities. Normally these rights are "pro-rata". There are variations but at the end of the day investors typically get the right to purchase whatever number of shares they need to buy to retain their ownership percentage prior to the next financing. Pre-emptive rights provide an opportunity to purchase later issuances, but does not include an obligation.

Tip #2: Investor Pitching

When you are interviewing angel investors (and that is the mental approach entrepreneurs should take), not only do you need to have your company's information available and organized, but you should come prepared with questions to help you find out what value (other than money) the investor can bring.

Consider industry experience, connections, and if he/she has co-invested with others who might be interested.

CONVERTIBLE SECURITIES

Convertible Notes

Convertible notes are structured as loans that convert to equity based on terms set by a future investor, and they are most commonly used in the earliest financing rounds and between major financing rounds in what are referred to as “bridge rounds”.

Other Convertible Securities

In addition to convertible notes, there are several other varieties of convertible securities (like SAFEs and KISSes) that are intended to provide a quick and efficient way for a company to raise money. Depending on the flavor, they can have features of either (or both) debt and equity.

Valuation

One of the major negotiating points in angel and venture financings is the valuation of the company. As mentioned above, agreeing to a valuation normally centers around market norms. Understanding this, investors and companies alike have become very comfortable in ignoring that point entirely by using convertible securities. Whether the Company sells convertible notes or some other type of convertible security, the

conversion, the question of valuation is essentially kicked down the road to a later time when there is more information available to use in a valuation.

Discount/Cap

When a convertible security is converted to stock, the conversion price is generally a discount to the price per share paid by the new investors (often between 10-25%). This discount is offered to account for the investor’s additional risk in putting their capital at risk before anyone else.

Valuation caps help provide a level of protection for investors, setting the highest valuation that can be used when determining conversion price. Investors will typically get the benefit of using the discount or the valuation cap, whichever results in a more favorable price. This is not always the case, though - some flavors of convertible securities provide for one or the other (a discount or a cap).

Interest Rate

Interest rates apply to convertible notes as they are essentially loans. Convertible notes normally differ from traditional loans in that interest accrues and is paid in additional shares upon conversion.

Conversion (Automatic and Optional)

Most convertible notes and other securities include an automatic conversion clause. This clause generally stipulates that a convertible note will convert into equity upon a qualified financing, which is a financing in which the Company raises a minimum amount of additional capital through the sale of equity securities. Many times convertible securities also include an optional conversion feature which allows the investor to convert at any time based on a pre-set company value.

Shadow Series

When a convertible note or other convertible security is converted into shares of preferred stock, the noteholder will either get shares that are exactly the same as those that are purchased in the financing by the other investors, or shares that are almost exactly the same.

If the noteholders receive shares that are almost the same, then they are said to be shares of a “shadow series” of preferred stock. Most of the time, the rights and privileges of the shadow series shares are the same except that the liquidation preference is equal to the conversion price instead of the full purchase price paid by the new investors.

If the notes or other convertible securities convert

into exactly the same shares as are sold in the preferred stock financing (not into a shadow series of preferred), then the note investors will get a built-in gain in the event the liquidation preference is triggered.

Maturity (Notes Only)

If a convertible note has not converted to equity by the time the maturity date arrives, the note is due for repayment to the investor (including any accrued interest). For a number reasons, both for the benefit of the startup and the investor, it is rare for an investor to call for a note at the maturity date. In most cases the maturity date is extended or the investor elects to convert the principal and interest due on the note into equity at the maturity date.

Tip #3: Investor Pitching

For early stage deals, keep your pitch deck simple (approximately 10 slides):

- Know what you’re asking for (We’re seeking \$1,000,000 so that we can do “X”).
- Feature your team near the front. They are the most important part of your company
- Feature intellectual property and inventions (Have a prototype? Bring it.)
- Address obstacles and potential pitfalls head on. If not it looks like you’re unaware or trying to hide something.
- Explain the market opportunity but don’t spend much time on your company’s financial projections.

EXPECTED FEES & EXPENSES

For startups raising seed-stage funding, it is most common for each party to cover their own legal fees and expenses. However, as you grow into later-stage rounds and larger deals, you can expect investors to request that you cover all legal fees and expenses.

When planning for these expenses, I advise that you set the expectation of reasonable legal fees and expenses and negotiate a cap on the fees of investor counsel.



NEXT STEPS

If you are the founder of a startup and have more questions about angel and venture financing, please [click here](#) to set a time to speak with a Fourscore lawyer.

We would love to talk with you about your business and how we can help. **The call is off the clock.**

You can also email us at info@fourscorelaw.com and we will be happy to set up a time to meet.

About Fourscore Business Law

Based in the Research Triangle region of North Carolina, Fourscore Business Law serves entrepreneurs and businesses in Raleigh, Durham, Chapel Hill, Wilmington, Charlotte and throughout the Southeast. We also represent venture capital funds and other investors who invest in companies located in New York, Silicon Valley and everywhere between.

FUNDING SOURCES IN NC & THE SOUTHEAST

Angel Investor Groups in North Carolina

Blue Ridge Angel Investor Network

Carolina Angel Network

Charlotte Angel Fund

Cofounders Capital

Duke Angel Network

IMAF - Cape Fear

IMAF - Charlotte

IMAF - East

IMAF - RTP

IMAF - Triad

IMAF - West

Piedmont Angel Network (PAN)

RTP Capital Associates

Triangle Angel Partners

Wilmington Investor Network

Wolfpack Investor Network

Angels and VCs in the Southeast

Angel Capital Association

Fulcrum Equity Partners

Moseley Ventures

Tech Operators

Tech Square Ventures

The Angel Roundtable

VentureSouth

Additional Resources

[Angel.co](#)

[Equitynet.com](#)

[Gust.com](#)

[Startups.co](#)

