

Keiretsu Forum

KEIRETSU



FORUM

“Great Association with Quality Deal Flow”

Agenda for the Series

1. Are you startup ready?
2. Stages of funding & Investor expectations
3. Fund raising 1 – Business models, business plans
4. Fund raising 2 – planning and executing the fund raise
5. Getting ready for due diligence
6. Valuation and Transaction documents

Agenda for today

- Deal Terms
- Deal Terms (with worked examples)
- Valuation Methodologies
(introduction)
- Deal Documentation
- Q&A

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Series on Getting Investment Ready
August and September 2020

VALUATION & TRANSACTION DOCUMENTS

Deal Terms

- Valuation
 - Pre-Money
 - Post-Money
- Per share value
 - Shares outstanding
 - “As converted”
 - Fully diluted
- Types of securities
 - Preference shares
 - Ordinary shares (common stock)
 - Convertible notes
- Liquidation preference
 - Participating
 - Non-participating

Deal Terms (continued)

- Anti-dilution Rights
 - Weighted average formula
 - Full-ratchet
 - Share issues that do not trigger any dilution (e.g. ESOP)
- Dividend Rights
 - Non-cumulative
 - Cumulative
 - Mandatory
- Protective Voting Rights
 - Capital structure change
 - Board change
 - Liquidity events

Deal Terms (continued)

- Board Representation
- Redemption Rights (rare for early stage)
- Rights of First Refusal (“ROFR”)
- Co-Sale Rights (Tag-Along)
- Drag-Along Rights
- Founder Terms
- Closing conditions

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SESSION 6 – VALUATION – A WORKED EXAMPLE

Deal Structuring – Pros & Cons

- Equity
- CCPS – Compulsorily Convertible Preference Shares
- Convertible Note



Valuation (Example for CCPS)

- Qualifying Funding (typically a Series “A”)
- Valuation Cap
- Discount
- Why Valuation and Discounts change over time
- What if there is no next round?
- → Liquidation Preference

Discounts and Valuation Cap

Terms of the Deal - A

- Investment – 20M
- Valuation Cap – 200M
- Applicable discount – 30% (also applies to cap)
- Applicable period – 24 months
- Actual Pre-Money Valuation of Qualifying Funding – 500M, and actual amount raised is 100M

Ownership - A

- Valuation Cap applies
- Ownership – 20M divided by (70% of 200M plus 20M); or 12.5%
- Diluted equity interest = $12.5\% \times (1 - 16.7\%)$, or 10.4%
- Value of the stake = 62.4M (10.4% of 600M)
- Notional Return = 212%; IRR = 92%, if 21 months

Discounts and Valuation Cap - 1

Terms of the Deal - A

- Investment – 20M
- Valuation Cap – 200M
- Applicable discount – 30%, **but not to the cap**
- Applicable period – 24 months
- Actual Pre-Money Valuation of Qualifying Funding – 500M, and actual amount raised is 100M

Ownership - A

- Valuation Cap applied
- Ownership – 20M divided by (200M plus 20M); or 9.1%
- Diluted equity interest = $9.1\% * (1 - 16.7\%)$, or 7.5%
- Value of the stake = 45M (7.5% of 600M)
- Notional Return = 125%; IRR = 59%, if 21 months

Discounts and Valuation Cap - 2

Terms of the Deal - B

- Investment – 20M
- Valuation Cap – 200M
- Applicable discount – 30%
- Applicable period – 24 months
- Actual Pre-Money Valuation of Qualifying Funding – 180M, and actual amount raised is 50M

Ownership - B

- Valuation Cap does not apply
- Ownership – 20M divided by (70% of 180M plus 20M); or 13.7%
- Diluted equity interest = $13.7\% * (1 - 21.7\%)$, or 10.7%
- Value of the stake = 24.7M (10.7% of 230M)
- Notional Return = 23%

Impact on Founders

Deal A

- Founders – 72.9% (74.2%)
- Angels – 10.4% (9.1%)
- VC (Series A) – 16.7%

Deal B

- Founders – 67.6%
- Angels – 10.7%
- VC (Series A) – 21.7%

Observations

- Higher the next round valuation, the better the return for angels despite the lower stake in the Company
- High valuation caps that fail in subsequent rounds reduce Founder interest, which is a concern
- There will still be a debate on valuation with conversion structures

Valuation linked to revenue

- If forward annual revenue $<$ INR 1 crore – pre-money valuation is INR 12 crores
- If revenue between INR 1 and 3 crores – pre-money valuation is INR 14 crores
- If revenue $>$ INR 3 crores, pre-money valuation is INR 16 crores

Liquidation Preference

- When is it triggered?
- Participating
- Non-participating
- Liquidation multiple
- Capped participation



Important for early stage

- Right to information
- Founder terms
- Closing conditions
- Preemption rights or Veto rights, for e.g.
 - Change of business
 - Fund raising or capital structure
- How to manage veto rights?

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SESSION 6 - VALUATION METHODOLOGIES

An imperfect world

- Comparable Public Valuation
- Comparable Exit Valuation
- Discounted Cash Flow
- Comparable Deal Valuation

Looking for that 10x Exit Value

Valuation – art not science

- Average valuation of startups that raised angel investment in the US is c.\$4.7 million (dated, but relevant)
- Higher the valuation expectation of the startup, the harder the process of winning over the angel investor – in fact, if the expectation is off-scale angel investors often don't even bother

Valuation (continued)

- At early stage, convertibles with valuation caps preferred to equity, but...
- The sophisticated startups also reduce the cap if there are changes in the roll out plan, typically because the fund raising is slower
- Remember the experienced angel investor knows that a third of his investment is a write-off ..., so she is entitled to caution

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SESSION 6 - TRANSACTION DOCUMENTS

Term Sheet

- Non-binding, but is usually respected by all parties
- Valuation and instrument of investment
- Liquidation preference
- Anti-dilution protection
- Affirmative rights
- Use of proceeds
- Governing law

Definitive Agreement

- Share Purchase Agreement
- Investor / Shareholder Rights Agreement
- Rights of First Refusal and Co-Sale Agreement
- Term sheet fleshed out

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QUESTIONS & ANSWERS

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